FORM 10QSB

Optional form for quarterly and transition reports of small business issuers under section 13 or 15(d)

Filing Date: **1999-09-10** | Period of Report: **1999-07-31**
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FILER

FATBRAIN COM INC

CIK:**1066010**| IRS No.: **770389480** | State of Incorp.:**DE** | Fiscal Year End: **0131**
Type: **10QSB** | Act: **34** | File No.: **000-24871** | Film No.: **99709099**
SIC: **5990** Retail stores, nec

Mailing Address
1308 ORLEANS DR
SUNNYVALE CA 94089

Business Address
1308 ORLEANS DR
SUNNYVALE CA 94089
4085412020

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-QSB

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

FOR THE QUARTERLY PERIOD ENDED JULY 31, 1999

OR

[ ] 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 0-24871

FATBRAIN.COM, INC.
(Exact name of small business issuer as specified in its charter)

DELAWARE	77-0389480
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)

2550 WALSH AVENUE
SANTA CLARA, CALIFORNIA 95051
(Address of principal executive offices)

(408) 845-0100
(Issuer's telephone number, including area code)

Indicate by check [X] whether the issuer (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 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

(1) Yes [X] No ___

(2) Yes [X] No ___

As of July 31, 1999 there were 11,340,384 shares of the Registrant's common stock outstanding.

FATBRAIN.COM, INC.

FORM 10-QSB

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS.

FATBRAIN.COM, INC.
CONDENSED BALANCE SHEETS
(in thousands, except per share data)

<TABLE>
<CAPTION>

<S>	January 31, 1999 <C>	July 31, 1999 (unaudited) <C>
ASSETS		
Current assets:		
Cash and equivalents	$ 9,341	$ 3,121
Short-term investments	5,344	--
Accounts receivable, net of allowance of $161 and $300	1,268	1,752
Inventories	3,204	5,871
Prepaid expenses and other current assets	1,068	1,514
Total current assets	20,225	12,258
Property and equipment, net	2,097	5,698
Investments	14,181	10,522
Goodwill, net	2,751	2,648
Other assets	360	371
Total assets	$ 39,614	$ 31,497
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 1,896	$ 4,456
Accrued expenses	1,169	1,341
Current portion of capital lease obligations	18	18
Total current liabilities	3,083	5,815
Capital lease obligations	35	27
Total liabilities	3,118	5,842
Stockholders' equity:		
Preferred stock, $0.001 par value, 5,000 authorized, none issued and outstanding	--	--
Common stock, $0.001 par value, 50,000 and 50,000 shares authorized, 11,172 and 11,340 shares issued and outstanding at January 31, 1999 and July 31, 1999, respectively	11	11
Additional paid-in capital	50,270	50,584
Warrants	12	12
Unrealized loss on investments	(47)	(64)
Accumulated deficit	(13,750)	(24,888)
Total stockholders' equity	36,496	25,655
Total liabilities and stockholders' equity	$ 39,614	$ 31,497

</TABLE>

See accompanying notes to condensed financial statements.

FATBRAIN.COM, INC.
CONDENSED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS
(in thousands, except per share data)

<TABLE>
<CAPTION>

	Three months ended July 31, 1998	Three months ended July 31, 1999	Six months ended July 31, 1998	Six months ended July 31, 1999
	(unaudited)		(unaudited)	
<S>	<C>	<C>	<C>	<C>
Revenues:				
Online	$ 2,464	$ 5,785	$ 4,225	$ 10,276
Retail and other	2,351	1,577	4,984	3,229
Total revenues	4,815	7,362	9,209	13,505
Cost of revenues:				
Online	1,965	4,529	3,291	8,172
Retail and other	1,538	1,033	3,226	2,104
Total cost of revenues	3,503	5,562	6,517	10,276
Gross profit	1,312	1,800	2,692	3,229
Operating expenses:				
Sales and marketing	2,070	5,266	4,056	9,936
Development and engineering	594	1,299	1,148	2,419
General and administrative	681	1,340	1,224	2,518
Total operating expenses	3,345	7,905	6,428	14,873
Loss from operations	(2,033)	(6,105)	(3,736)	(11,644)
Interest, net	67	177	99	506
Net loss	(1,966)	(5,928)	(3,637)	(11,138)
Other comprehensive loss - unrealized loss on investments	--	(13)	--	(17)
Comprehensive loss	$(1,966)	$(5,941)	$(3,637)	$(11,155)
Basic and diluted net loss per share	$ (1.28)	$ (0.52)	$ (2.37)	$ (0.99)
Shares used in calculating basic and diluted net loss per share	1,539	11,300	1,533	11,263

</TABLE>

See accompanying notes to condensed financial statements.

FATBRAIN.COM, INC.
CONDENSED STATEMENTS OF CASH FLOWS
(in thousands)

<TABLE>
<CAPTION>

	Three months ended July 31, 1998	Three months ended July 31, 1999	Six months ended July 31, 1998	Six months ended July 31, 1999
	(unaudited)		(unaudited)	
<S>	<C>	<C>	<C>	<C>
Cash flows from operating activities:				
Net loss	$(1,966)	$(5,928)	$(3,637)	$(11,138)
Adjustments to reconcile net loss to net cash used in operations:				
Depreciation and amortization	125	281	232	516
Options granted to consultants	--	--	5	--
Amortization of premium on investments	--	102	--	193
Changes in current assets and liabilities:				
Accounts receivable	35	(384)	(358)	(484)

Inventories	(622)	(379)	(296)	(2,667)
Prepaid expenses and other assets	(676)	284	(613)	(478)
Accounts payable	1,005	251	(42)	2,560
Accrued expenses	(79)	(252)	(87)	172
Net cash used in operations	(2,178)	(6,025)	(4,796)	(11,326)
Cash flows from investing activities:				
Purchase of property and equipment	(402)	(2,534)	(645)	(3,993)
Sale of investments	--	4,504	--	8,793
Net cash (used in)/provided by investing activities	(402)	1,970	(645)	4,800
Cash flows from financing activities:				
Repayment of capital lease obligation	(5)	(4)	(9)	(8)
Issuance of preferred stock, net	5,499	--	5,524	--
Net exercise of stock options and warrants	84	31	84	87
Employee stock purchase plan purchases	--	227	--	227
Net cash provided by financing activities	5,578	254	5,599	306
Net increase (decrease) in cash and equivalents:	2,998	(3,801)	158	(6,220)
Cash and equivalents at beginning of period	2,134	6,922	4,974	9,341
Cash and equivalents at end of period	$ 5,132	$ 3,121	$ 5,132	$ 3,121
Non-cash investing activity:				
Unrealized loss on investments	--	(13)	--	(17)
Supplemental disclosure of cash flow information:				
Cash paid for interest	1	2	3	3
Cash paid for income tax	--	--	--	--

</TABLE>

See accompanying notes to condensed financial statements.

FATBRAIN.COM, INC.

NOTES TO CONDENSED FINANCIAL STATEMENTS

1. BUSINESS AND SIGNIFICANT ACCOUNTING POLICIES

Description of Business and Basis of Presentation

Fatbrain.com, Inc., formerly Computer Literacy, Inc., (the "Company") was incorporated in California in November 1994 and reincorporated in Delaware in May 1998. The Company is an online retailer of professional books, technology based training solutions, product manuals, research reports and other information resources, all of which are targeted to business and technical professionals. Business is transacted through the Company's online store or through its two physical retail locations. On March 29, 1999, the Company changed its name to Fatbrain.com, Inc.

Unaudited Interim Financial Information

The condensed financial statements of Fatbrain.com, Inc. included herein are unaudited and reflect all adjustments (consisting only of normal recurring adjustments) which are, in the opinion of management, necessary for a fair presentation of the financial position and operating results for the three and six months ended July 31, 1998 and July 31, 1999. These financial statements should be read in conjunction with the Company's audited financial statements as of January 31, 1999 and for the year then ended and notes thereto included in the Company's April 16, 1999 filing on Form 10-KSB. The results of operations for the three and six months ended July 31, 1999 are not necessarily indicative of the results to be expected for any subsequent quarter or for the year ending January 31, 2000.

2. SEGMENT INFORMATION

On January 31, 1999, the Company adopted SFAS No. 131, "Disclosures About Segments of an Enterprise and Related Information," which established standards for reporting information about operating segments in annual financial statements, along with related disclosures about products and services, geographic areas, and major customers. The information for the three and six months ended July 31, 1998 has been reclassified from the prior year's presentation to conform to the presentation for the three and six months ended July 31, 1999.

Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the Company's chief operating decision maker. By this definition, Fatbrain.com has three operating segments: internet commerce, retail stores, and online advertising. The segments presented here are those that were presented in the Company's filing on form 10-KSB for the year ended January 31, 1999, with the addition of the online advertising segment. These segments are differentiated based upon one of two criteria: the methods used to distribute product, or the nature of the product or service provided. For the internet commerce segment, products are ordered via the Company's web site and mailed directly to the customer through the Company's distribution system. The retail stores maintain inventory within the store in a traditional retail environment. These operating segments had similar product offerings in the three and six months ended July 31, 1998 and in the three and six months ended July 31, 1999. The online advertising segment generates revenue through the sale of advertising space on the Company's website. The Company began generating online advertising revenues in the quarter ended April 30, 1999. Unallocated revenues are generated primarily from trade shows and book fairs.

The Company evaluates segment performance based on gross profit. The Company does not analyze the segments individually below the gross profit line. Direct operating expenses are those directly related to the operating segment (for example, direct salaries, rent, etc.) and exclude all corporate overhead expenses. Segment assets are not presented as all assets of the Company are commingled and are not available by segment. The accounting policies of the segments are the same as those described in the summary of significant accounting policies.

SEGMENT CONTRIBUTION

<TABLE>
<CAPTION>

	Three months ended July 31,		Six months ended July 31,	
	1998	1999	1998	1999
	(in thousands)		(in thousands)	
<S>	<C>	<C>	<C>	<C>
Revenues (1):				
Internet commerce	$ 2,464	$ 5,625	$ 4,225	$ 9,831
Retail stores	2,343	1,576	4,973	3,195
Online advertising	--	160	--	445
Unallocated	8	1	11	34
Consolidated net revenues	4,815	7,362	9,209	13,505
Gross profit (1):				
Internet commerce	499	1,096	934	1,659
Retail stores	803	544	1,770	1,113
Online advertising	--	160	--	445
Unallocated	10	0	(12)	12
Consolidated margin	1,312	1,800	2,692	3,229
Contribution (2):				
Internet commerce	(49)	(438)	(21)	(1,082)
Retail stores	176	132	500	299
Online advertising	--	160	--	445
Unallocated	9	(3)	(15)	(12)
Consolidated contribution	$ 136	$ (149)	$ 464	$ (350)

</TABLE>

(1) The presentation of revenues and gross profit is consistent with the Company's internal presentation of financial information to management.

(2) Contribution is defined as gross profit, less direct operating expenses.

RECONCILIATION OF CONTRIBUTION TO NET LOSS

<TABLE>

<S>	<C>	<C>	<C>	<C>
Consolidated Contribution	$ 136	$ (149)	$ 464	$ (350)
Interest income, net	67	177	99	506
Indirect expenses	(2,169)	(5,956)	(4,200)	(11,294)
Net loss	$(1,966)	$(5,928)	$(3,637)	$(11,138)

</TABLE>

Geographic information. International sales, measured as shipments to addresses outside the United States were 13% and 11%, respectively, of total revenues for the three and six month periods ended July 31, 1998 and 11% and 12%, respectively, of total revenues for the three and six month periods ended July 31, 1999. No foreign country or geographical area accounted for more than 10% of revenue in any of the periods presented.

Major customers. No individual customer accounted for 10% or more of the Company's consolidated revenues for the three and six months ended July 31, 1998 and July 31, 1999.

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

The following discussion and analysis of financial conditions and results of operations contains forward-looking statements that involve risks and uncertainties. Our actual results could differ materially from those discussed herein. Factors that could cause or contribute to such differences include, but are not limited to, those discussed in "Risk Factors That May Affect Future Results" as well as those discussed in this section and elsewhere in this Report, and the risks discussed in the "Risk Factors" section included in our Registration Statement on Form SB-2 as declared effective by the Securities and Exchange Commission on November 19, 1998 (Reg. No. 333-67397).

OVERVIEW

Fatbrain.com, Inc. is the leading online retailer of information resources singularly focused on technical and business professionals. With over 300,000 information resource titles from more than 8,000 publishers, we offer our customers online access to a broad and comprehensive selection of technical and professional books, technology based training solutions, product manuals, research reports and other information resources. In addition to our extensive product offering, our online store features authoritative and compelling content, competitive pricing, an easy-to-use navigational interface and a variety of value-added services. We also operate two physical retail stores that complement our online business by generating increased online traffic and creating cross-promotional opportunities.

We were incorporated in November 1994 as Computer Literacy Corporation and began selling technical books in February 1996, technology based training solutions in January 1998, product manuals in May 1998, research reports in June 1998, and professional resources for the engineering, science, mathematics and financial services industries in March 1999. We generate revenues from sale of these products through our online store, certain co-branded corporate online stores and our two retail locations as well as through trade shows and book fairs. We recognize revenue from our online store upon shipment and, from our physical retail stores, trade shows and book fairs, at the time of sale. In the three and six month periods ended July 31, 1999, we generated additional revenue by selling advertising space on our web site.

Cost of revenues includes costs of products and inbound and outbound freight. These costs may vary as a percentage of total revenues in any given period due to a number of factors, including increased price competition, varied levels of cooperative advertising dollars received from certain publishers of books, changes in the size and timing of discounts and other promotional activities, and changes in product mix. For the three month periods ended July 31, 1998 and July 31, 1999, we purchased approximately 34% and 35%, respectively, of our books from Ingram Book Company ("Ingram"), an indirect reseller. In the six month periods ended July 31, 1998 and July 31, 1999 we purchased approximately 36% and 37%, respectively, of our books from Ingram. Although the primary advantage associated with purchasing from Ingram is just in time inventory management, we believe we will make a larger number of our purchases directly from publishers as our sales volume increases, thereby enabling us to take advantage of favorable volume discounts. For the three and six month periods ended July 31, 1999 we purchased approximately 17% and 18%, respectively, of our books from Pearson Education Division.

Since inception, we have incurred significant net operating losses and expect to incur additional net operating losses for the foreseeable future. There can be no assurance that we will achieve profitability or that, if profitability is achieved, it will be sustained. As of July 31, 1999 we had an accumulated deficit of $24.9 million. We believe that our success will depend in large part on our ability to enhance our customers' online shopping experience, expand corporate relationships, build brand awareness, encourage customer loyalty, capitalize on the market for information resources, establish and leverage supplier relationships, maintain our technical focus and expand our expertise in the engineering, science, mathematics and financial services industries. Accordingly, we intend to invest heavily in marketing and promotion, our direct sales and telesales organizations, and infrastructure development. There can be no assurance that such expenditures will result in increased revenues or customer growth. Additionally, while in recent periods we have experienced significant growth in revenues, our customer base and repeat customer revenue, such growth rates are not sustainable, will decrease in the future and are not indicative of actual growth rates that we may experience. In view of the rapidly evolving nature of our business and our limited operating history, we believe that period-to-period comparisons of our operating results, including our operating

expenses as a percentage of total revenues, are not necessarily meaningful and should not be relied upon as an indication of future performance. See "Risk Factors--Limited Operating History; Accumulated Deficit; Anticipated Losses."

RESULTS OF OPERATIONS

The following table presents the Company's results of operations as a percentage of total revenues for the periods indicated.

<TABLE>
<CAPTION>

	Quarter ended July 31,		Six months ended July 31,	
	1998	1999	1998	1999
<S>	<C>	<C>	<C>	<C>
Revenues:				
Online	51.2%	78.6%	45.9%	76.1%
Retail and other	48.8	21.4	54.1	23.9
Total revenues	100.0	100.0	100.0	100.0
Cost of revenues (1):				
Online	79.7	78.3	77.9	79.5
Retail and other	65.4	65.5	64.7	65.2
Total cost of revenues	72.8	75.6	70.8	76.1
Gross profit	27.2	24.4	29.2	23.9
Operating expenses:				
Sales and marketing	43.0	71.5	44.0	73.6
Development and engineering	12.3	17.6	12.5	17.9
General and administrative	14.1	18.2	13.3	18.6
Total operating expenses	69.4	107.3	69.8	110.1
Loss from operations	(42.2)	(82.9)	(40.6)	(86.2)
Interest, net	1.4	2.4	1.1	3.7
Net loss	(40.8)%	(80.5)%	(39.5)%	(82.5)%

</TABLE>

(1) Cost of online revenue and cost of retail and other revenue are shown as a percentage of related online revenue and retail and other revenue, respectively.

THREE MONTHS ENDED JULY 31, 1998 COMPARED TO THREE MONTHS ENDED JULY 31, 1999

Online Revenue. Online revenue is comprised of revenue from online sales of information resources, associated outbound shipping charges, net of returns and, to a lesser extent, the sale of advertising space on our web site. Online revenue increased from $2.5 million, or 51.2% of total revenues in the three months ended July 31, 1998, to $5.8 million, or 78.6% of total revenues in the three months ended July 31, 1999 primarily as a result of significant increases in our customer base (from 44,302 to 138,725), and repeat purchases from our existing customers.

International sales represented approximately 26% and 14% of online revenue for the three months ended July 31, 1998 and the three months ended July 31, 1999, respectively.

Retail and Other Revenue. Retail and other revenue is comprised primarily of revenue generated by our physical retail stores and, to a lesser extent, by trade shows and book fairs. Retail and other revenue decreased from $2.4 million, or 48.8% of total revenues for the three months ended July 31, 1998, to $1.6 million, or 21.4% of total revenues in the three months ended July 31, 1999, primarily as a result of an increased focus of our sales and marketing on the online business, as well as the closure of two retail stores, located in Cupertino, California and Vienna, Virginia, at the end of fiscal 1999. The

Company periodically evaluates the location and productivity of its retail stores and may close, consolidate or relocate stores as conditions warrant. Any closure, consolidation or relocation of a retail store is likely to decrease retail and other revenue.

Cost of Online Revenue. Cost of online revenue is comprised primarily of the cost of merchandise sold through our online store and associated inbound and outbound shipping costs. Cost of online revenue increased from $2.0 million, or 79.7% of online revenue for the three months ended July 31, 1998, to $4.5 million, or 78.3% of

online revenue in the three months ended July 31, 1999. The increase in absolute dollars was attributable to increased online sales volume.

Cost of Retail and Other Revenue. Cost of retail and other revenue is comprised of the cost of merchandise sold through our retail stores and at trade shows and book fairs and includes associated inbound and outbound shipping costs. Cost of retail and other revenue decreased from $1.5 million, or 65.4% of retail and other revenue in the three months ended July 31, 1998, to $1.0 million, or 65.5% of retail and other revenue in the three months ended July 31, 1999 primarily as a result of the decrease in retail and other sales.

Gross Profit. Gross profit as a percentage of total revenues decreased from 27.2% in the three months ended July 31, 1998 to 24.4% in the three months ended July 31, 1999. The percentage decrease was primarily a result of the increase in online sales as a percent of total revenues, as well as our implementation of an online competitive pricing policy. We have offered, and expect to continue to offer in the foreseeable future, discounts on various product offerings to encourage new customers and online traffic. Such pricing pressure is likely to reduce gross margins in the future but may be partially offset by the change in mix of products sold towards higher margin technology based training materials, product manuals and research reports.

Sales and Marketing Expenses. Sales and marketing expenses consist of direct expenses associated with our retail stores, as well as advertising, promotional and public relations expenditures, payroll and related expenses for personnel engaged in corporate sales, marketing and fulfillment. Sales and marketing expenses increased from $2.1 million, or 43.0% of total revenues in the three months ended July 31, 1998, to $5.3 million, or 71.5% of total revenues in the three months ended July 31, 1999. The increase in absolute dollars was primarily attributable to the expansion of our online store and its direct sales force, plus an increase in advertising, branding, public relations and other promotional expenditures to support our name change. The increase was also due to the increased personnel and related expenses required to implement our marketing strategy and fulfill customer demand. We intend to continue to pursue aggressive branding, marketing and telesales campaigns to generate increased online traffic and acquire customers. Accordingly, we expects sales and marketing expenses to increase in absolute dollars for the foreseeable future, but decrease as a percentage of total revenues as total revenues increase.

Development and Engineering Expenses. Development and engineering expenses primarily consist of costs associated with systems and telecommunications infrastructure, editorial operations and content acquisition. Development and engineering expenses increased from $594,000, or 12.3% of total revenues in the three months ended July 31, 1998, to $1.3 million, or 17.6% of total revenues in the three months ended July 31, 1999. The increase in absolute dollars was primarily attributable to increased staffing and associated costs related to enhancing the features, content and functionality of our online store and transaction-processing systems, as well as increased investments in systems and telecommunications infrastructure. To date, all development and engineering costs have been expensed as incurred. We believe that continued investment in systems and infrastructure development is critical to attaining our strategic objectives and, as a result, expect development and engineering expenses to increase significantly in absolute dollars for the foreseeable future, but decrease as a percentage of total revenues as total revenues increase.

General and Administrative Expenses. General and administrative expenses consist of payroll and related costs associated with executive, accounting and administrative personnel, recruiting, professional service fees and other general corporate expenses. General and administrative expenses increased from $681,000, or 14.1% of total revenues in the three months ended July 31, 1998, to $1.3 million or 18.2% of total revenues in the three months ended July 31, 1999. This increase in absolute dollars was primarily due to increased salaries and related expenses associated with the hiring of additional personnel and increases in professional fees. We expect general and administrative expenses to increase in absolute dollars as we expand our staff and incur additional costs related to the expansion of our business and the costs resulting from being a public company, but decrease as a percentage of total revenues as total revenues increase.

Interest, Net. Net interest income increased from $67,000 in the three months ended July 31, 1998, to $177,000 in the three months ended July 31, 1999 due to interest earned on the remaining proceeds from our initial public offering in November 1998.

SIX MONTHS ENDED JULY 31, 1998 COMPARED TO SIX MONTHS ENDED JULY 31, 1999

Online Revenue. Online revenue increased from $4.2 million, or 45.9% of total revenues in the six months ended July 31, 1998, to $10.3 million, or 76.1% of total revenues in the six months ended July 31, 1999 primarily as a result of significant increases in our customer base (from 44,302 to 138,725), and repeat purchases from our existing customers.

International sales represented approximately 23% and 16% of online revenue for the six months ended July 31, 1998 and the six months ended July 31, 1999, respectively.

Retail and Other Revenue. Retail and other revenue decreased from $5.0 million, or 54.1% of total revenues for the six months ended July 31, 1998, to $3.2 million, or 23.9% of total revenues in the six months ended July 31, 1999 primarily as a result of an increased focus of our sales and marketing on the online business, as well as the closure of two retail stores, located in Cupertino, California and Vienna, Virginia, at the end of fiscal 1999.

Cost of Online Revenue. Cost of online revenue increased from $3.3 million, or 77.9% of online revenue for the six months ended July 31, 1998, to $8.2 million, or 79.5% of online revenue in the six months ended July 31, 1999. The increase in absolute dollars was attributable to increased online sales volume.

Cost of Retail and Other Revenue. Cost of retail and other revenue decreased from $3.2 million, or 64.7% of retail and other revenue in the six months ended July 31, 1998, to $2.1 million, or 65.2% of retail and other revenue in the six months ended July 31, 1999 primarily as a result of the decrease in retail and other sales.

Gross Profit. Gross profit as a percentage of total revenues decreased from 29.2% in the six months ended July 31, 1998 to 23.9% in the six months ended July 31, 1999 as the higher margin retail and other revenue represented a smaller portion of total revenue.

Sales and Marketing Expenses. Sales and marketing expenses increased from $4.1 million, or 44.0% of total revenues in the six months ended July 31, 1998, to $9.9 million, or 73.6% of total revenues in the six months ended July 31, 1999. The increase in absolute dollars was primarily attributable to the expansion of our online store and its direct sales force, plus an increase in advertising, branding, public relations and other promotional expenditures to support our name change. The increase was also due to the increased personnel and related expenses required to implement our marketing strategy and fulfill customer demand.

Development and Engineering Expenses. Development and engineering expenses increased from $1.1 million, or 12.5% of total revenues in the six months ended July 31, 1998, to $2.4 million, or 17.9% of total revenues in the six months ended July 31, 1999. The increase in absolute dollars was primarily attributable to increased staffing and associated costs related to enhancing the features, content and functionality of our online store and transaction-processing systems, as well as increased investments in systems and telecommunications infrastructure.

General and Administrative Expenses. General and administrative expenses increased from $1.2 million, or 13.3% of total revenues in the six months ended July 31, 1998, to $2.5 million or 18.6% of total revenues in the six months ended July 31, 1999. This increase in absolute dollars was primarily due to increased salaries and related expenses associated with the hiring of additional personnel and increases in professional fees.

Interest, Net. Net interest income increased from $99,000 in the six months ended July 31, 1998, to $506,000 in the six months ended July 31, 1999 due to interest earned on the remaining proceeds from our initial public offering in November 1998.

LIQUIDITY AND CAPITAL RESOURCES

Since inception, we have financed our operations primarily through private sales of preferred stock which totaled approximately $19.3 million (net of issuance costs), and public sale of common stock in our initial public offering in November 1998 which totaled approximately $30.8 million net of issuance costs.

Net cash used in operating activities was $2.2 million in the three months ended July 31, 1998 and $6.0 million in the three months ended July 31, 1999. Cash used in operating activities in the three months ended July 31,

1998 was primarily attributable to a net loss of $2.0 million and increases of $622,000 and $676,000, respectively, in inventories and prepaid expenses and other assets, partially offset by an increase of $1.0 million in accounts payable, as well as depreciation and amortization. For the three months ended July 31, 1999, cash used in operating activities primarily resulted from a net loss of $5.9 million plus increases of $384,000 and $379,000, respectively, in accounts receivable and inventories and a decrease of $252,000 in accrued expenses, offset by a decrease in prepaid expenses and other assets of $284,000 and an increase in accounts payable of $251,000, as well as depreciation and amortization.

Net cash used in operating activities was $4.8 million in the six months ended July 31, 1998 and $11.3 million in the six months ended July 31, 1999. Cash used in operating activities in the six months ended July 31, 1998 was primarily attributable to a net loss of $3.6 million and increases of $358,000, $296,000 and $613,000, respectively, in accounts receivable, inventories and prepaid expenses and other assets, partially offset by depreciation and amortization. For the six months ended July 31, 1999, cash used in operating activities primarily resulted from a net loss of $11.1 million plus increases of $484,000, $2.7 million and $478,000, respectively, in accounts receivable, inventories, and prepaid expenses and other current assets, partially offset by a $2.6 million increase in accounts payable, as well as depreciation and amortization.

Net cash used in investing activities was $402,000 in the three months ended July 31, 1998, and was attributable to purchases of property and equipment. Net cash provided by investing activities was $2.0 million in the three months ended July 31, 1999 and was attributable to $4.5 million in sales of investments, offset by $2.5 million used to purchase property and equipment. Net cash used in investing activities was $645,000 in the six months ended July 31, 1998, and was attributable to purchases of property and equipment. Net cash provided by investing activities was $4.8 million in the six months ended July 31, 1999 and was attributable to $8.8 million in sales of investments, offset by $4.0 million used to purchase property and equipment.

Cash provided by financing activities was $5.6 million in the three months ended July 31, 1998 and was primarily attributable to a $5.5 million preferred stock issuance. Cash provided by financing activities was $254,000 in the three months ended July 31, 1999 and was due primarily to $227,000 in purchases under our employee stock purchase plan, as well as stock option exercises. Cash provided by financing activities was $5.6 million in the six months ended July 31, 1999. Cash provided by financing activities was $306,000 in the six months ended July 31, 1999. We have a $4.0 million line of credit which expires on December 31, 1999. As of July 31, 1999, we had no borrowings outstanding under our line of credit.

As of July 31, 1999 we had $3.1 million of cash and equivalents and $10.5 million of investments. As of that date, our principal commitments consisted of obligations outstanding under an agreement with CBT Systems, Ltd. and operating and capital leases. Although we have no material long-term commitments for capital expenditures, we anticipate a substantial increase in our capital expenditures and lease commitments consistent with anticipated growth in operations, infrastructure and personnel.

RISK FACTORS THAT MAY AFFECT FUTURE RESULTS

We operate in a rapidly changing environment that involves a number of risks, some of which are beyond our control. The following discussion highlights some of these risks. These risks should be read in conjunction with the "Risk Factors" section included in our Registration Statement on Form SB-2 as declared effective by the Securities and Exchange Commission on November 19, 1998 (Reg. No. 333-67397).

LIMITED OPERATING HISTORY; ACCUMULATED DEFICIT; ANTICIPATED LOSSES

We were incorporated in November 1994 to develop an online retail strategy and we began selling information resources, initially consisting of technical books, through our online store on the World Wide Web (the "Web") in February 1996. We expanded our product offerings to include training materials in January 1998, product manuals in May 1998, research reports in June 1998 and professional resources for the engineering, science, mathematics and financial services industries in March 1999. Accordingly, we have a very limited operating history from which to evaluate our business and prospects.

Our prospects must be considered in light of the risks, expenses and uncertainties frequently encountered by companies in the early stages of development, particularly companies in new and rapidly evolving markets such as electronic commerce. Such risks for us may include:

- An evolving and unpredictable business model;
- Management of an expanding business;
- Fluctuations in sales;
- Seasonality;
- Entry into new business areas;
- Competition;
- Need for additional personnel and dependence on key personnel;
- Limitations on our ability to establish and expand our brand;
- Capacity constraints;
- Systems failures;
- Announcements by current or potential competitors;
- Changes in the needs of technical and business professionals; and
- The other Risk Factors discussed herein.

To address these risks, we must, among other things:

- Implement and successfully execute our business and marketing strategy;
- Maintain and increase our customer base;
- Continue to develop and upgrade our technology and transaction-processing systems;
- Improve our online store;
- Provide superior customer service and order fulfillment;
- Respond to competitive developments; and
- Attract, retain and motivate qualified personnel.

We may not be successful in addressing such risks, and the failure to do so would seriously harm our business, financial condition, results of operations, and cash flows.

Since inception, we have incurred significant net operating losses and expect to incur additional net operating losses for the foreseeable future. We may not achieve profitability and if achieved, profitability may not be sustained. As of July 31, 1999, we had an accumulated deficit of $24.9 million. We believe that our success will depend in large part on our ability to:

- Enhance our customers' online shopping experience;
- Expand corporate relationships;
- Build brand awareness;

- Encourage customer loyalty;
- Capitalize on the market for information resources;
- Establish and utilize supplier relationships;
- Maintain our technology focus and expertise; and
- Expand our expertise in the engineering, science, mathematics and financial services industries.

Accordingly, we intend to invest heavily in marketing and promotion, our direct sales and telesales organizations, and systems and infrastructure development. Such expenditures may not result in increased revenues or customer growth. Additionally, while in recent periods we have experienced significant growth in revenues, our customer base and repeat customer revenue, such growth rates are not sustainable. Such growth rates will decrease in the future and are not indicative of actual growth rates that we may experience.

UNPREDICTABILITY OF FUTURE REVENUES; POTENTIAL FLUCTUATIONS IN QUARTERLY OPERATING RESULTS; SEASONALITY

We are unable to accurately forecast our future revenues because of our limited operating history and the emerging nature of the markets in which we compete. Revenues and operating results generally depend on the volume of, timing of and ability to fulfill orders received. These factors have historically been, and are likely to continue to be, difficult to forecast. Our current and future expense levels are based largely on our operating plans and estimates of future revenues and are, to a large extent, fixed. We may be unable to adjust spending sufficiently quickly to compensate for any unexpected revenue shortfall. Accordingly, any significant shortfall in revenues in relation to our planned expenditures would seriously harm our business, financial condition, results of operations, and cash flows. Further, we may, from time to time, make certain pricing, product, service or marketing decisions as a strategic response to changes in the competitive environment. Such changes could seriously harm our business, financial condition, results of operations, and cash flows.

Our future quarterly operating results may vary significantly due to a variety of factors, many of which are outside our control. Factors that could affect our quarterly operating results include:

- Our ability to establish and expand brand awareness;

- Our ability to retain existing customers, attract new customers and continuously improve customer satisfaction;

- Announcements of, and market anticipation for, new technology offerings for which information resources may be sought;

- Our ability to manage inventory and fulfillment operations;

- Our ability to sustain or improve gross margin levels;

- The announcement or introduction of new online stores, services and products by us or our competitors;

- Price competition or higher wholesale prices in the industry;

- The level of usage of and commerce on the Internet and online services generally;

- Increasing customer acceptance of the Internet for the purchase of information resources such as those offered by us;

- Our ability to upgrade and develop our systems and infrastructure in a timely and effective manner;

- The level of traffic on our online store;

- The sales mix of our product offerings;

- Technical difficulties, system downtime or Internet brownouts;

- The amount and timing of operating costs and capital expenditures relating to expansion of our business, operations and infrastructure;

- The introduction of books, technology based training solutions, product manuals, and research reports;

- The level of merchandise returns we experience;

- Governmental regulation; and

- General economic conditions and economic conditions specific to the Internet, electronic commerce and the technical and professional resource industries.

In the past, we have experienced seasonality in our business and we expect that we will continue to experience such seasonality in the future. Internet usage and the amount of purchases from individual and corporate consumers tend to decline during August, November and December. During these times many technical and business professionals are either absent from the workplace, on vacation or experience a holiday closure at their company. Our results in future quarters may be negatively affected by seasonal trends.

Due to the foregoing factors, we cannot predict with any significant degree of certainty our quarterly revenue and operating results. Further, we believe that period-to-period comparisons of our operating results are not necessarily a meaningful indication of future performance. It is likely that in one or more future quarters our results may fall below the expectations of securities analysts and investors. In such event, the trading price of the Common Stock would likely be seriously harmed.

RISKS ASSOCIATED WITH ENTRY INTO NEW BUSINESS AREAS

For the three and six month periods ended July 31, 1999 approximately 81% of our online revenues were derived from sales of books. We recently expanded our product offerings to include technology based training materials, product manuals and research reports, and future revenues from these new product offerings are difficult to forecast. Additionally, we expanded our focus to include resource materials for professionals in the engineering, science, mathematics and financial services industries, and future revenues from these new areas are difficult to forecast.

We may choose to further expand our operations by promoting new or complementary products and expanding the breadth and depth of products and services offered. In addition, we may decide to utilize third-party relationships to extend our brand or establish additional co-branded online stores. We may pursue the acquisition of new or complementary businesses, products or technologies. However, we have no present commitments or agreements for any material acquisitions or investments. We may not be able to expand our product offerings and related operations in a cost-effective or timely manner. Such efforts may fail to increase online traffic and purchases from our online or physical retail stores or to increase our overall market acceptance. Furthermore, any new business or online store launched by us that is not favorably received by individuals, corporate customers or their employees or constituents could damage our reputation or the Fatbrain.com brand. Expansion of our operations in this manner would also require significant additional expenses and development, operations and editorial resources. Such efforts may strain our management, financial and operational resources. The lack of market acceptance of such efforts (including our recent expansion of product offerings to include technology based training materials, manuals and research reports, as well as our expanded focus in new industries) or our inability to generate satisfactory revenues from such expanded services or products to offset related increased costs could seriously harm our business, financial condition, results of operations, and cash flows.

COMPETITION

The electronic commerce market is new, rapidly evolving and intensely competitive. The market for information resources is more mature but also intensely competitive. We expect competition to continue to intensify in the future. We currently or potentially compete with a variety of companies. These competitors include:

- A significant number of traditional retail and online bookstores, including Amazon.com, Barnesandnoble.com, Borders Group, Inc. and other vendors of books, training products and product manuals;

- Various computer super-stores that carry related technical information resources at retail locations, in catalogs and over the Internet;

- A number of indirect competitors that specialize in electronic commerce or derive a substantial portion of their revenue from electronic commerce; and

- Other companies with substantial customer bases in the computer and other technical and professional fields.

We may not be able to maintain a competitive position against current or future competitors as they enter the markets in which we compete. This is true particularly with respect to competitors with greater financial, marketing, service, support, technical and other resources than Fatbrain.com. Our failure to maintain a competitive

position within the market could seriously harm our business, financial condition, results of operations, and cash flows.

We believe that the principal competitive factors on which we compete in our market include:

- Brand recognition;
- Selection;
- Personalized services;
- Convenience;
- Price;
- Accessibility;
- Customer service;
- Quality of search tools;
- Quality of editorial and other site content; and
- Reliability and speed of fulfillment.

Many of our current and potential competitors have longer operating histories, larger customer bases, greater brand recognition and significantly greater financial, marketing and other resources than Fatbrain.com. In addition, online retailers may be acquired by, receive investments from or enter into other commercial relationships with larger, well-established and well-financed companies as use of the Internet and other online services increases. Certain of our competitors may be able to secure merchandise from vendors on more favorable terms, devote greater resources to marketing and promotional campaigns, adopt more aggressive pricing or inventory availability policies and devote substantially more resources to Web site and systems development than we can.

Increased competition may result in reduced operating margins, loss of market share and a diminished brand franchise. We may from time to time make certain pricing, service or marketing decisions or acquisitions as a strategic response to changes in the competitive environment. Such actions could result in reduced margins or otherwise seriously harm our business, financial condition, results of operations, and cash flows.

New technologies and the expansion of existing technologies may increase the competitive pressure we experience. For example, applications that select specific titles from a variety of Web sites may channel customers to online booksellers that are our competitors. Companies that control access to transactions through a network or Web browsers could also promote our competitors or charge us a substantial fee for inclusion. In addition, vendors of information resources such as technology based training materials could provide direct access to training programs online. We may be unable to compete successfully against current and future competitors, and competitive pressures faced by us could seriously harm our business, financial condition, results of operations, and cash flows.

MANAGEMENT OF EXPANDING BUSINESS; LIMITED SENIOR MANAGEMENT RESOURCES

We have rapidly expanded our operations, and we anticipate that further expansion will be required to address potential growth in our customer base and market opportunities. Specifically, we expect to significantly increase our direct corporate and telesales organization and marketing initiatives. This expansion has placed, and future expansion is expected to place, a significant strain on our management, operational and financial resources. Our new employees include a number of key managerial, technical and operations personnel who have not yet been fully integrated into the Company, and we expect to add additional key personnel in the near future.

To manage the expected growth of our operations and personnel, we will need to improve existing and implement new transaction-processing, operational and financial systems, procedures and controls. In addition, we will need to expand, train and manage an increasing employee base. We will also need to expand our finance, administrative and operations staff. Our management will be required to maintain and expand our relationships with:

- Various suppliers;
- Freight companies;
- Other Web sites;
- Other Web service providers;

- Internet and other online service providers; and

- Other third parties necessary to our business.

Our current and planned personnel, systems, procedures and controls may be inadequate to support our future operations. Further, management may be unable to attract, retain, motivate and manage required personnel or to successfully identify, manage and exploit existing and potential market opportunities. If we are unable to manage growth effectively, our business, financial condition, results of operations, and cash flows could be seriously harmed.

RISKS ASSOCIATED WITH NEW BRAND

We believe we must establish, maintain and enhance our "Fatbrain.com" brand. We have only been operating under the "Fatbrain.com" name since the end of March 1999. To attract and retain online users and to promote and maintain our new brand, we may need to substantially increase our marketing expenditures to create and maintain strong brand loyalty among our customers. Additionally, customers may react negatively to our new brand. Our business could be adversely affected if our customers react negatively, our marketing efforts are unproductive or if we cannot increase our brand awareness and acceptance. If we fail to promote and maintain our brand, or if we incur excessive expenses in an attempt to do so, our business, results of operations, financial condition and cash flows would be seriously harmed.

RISK OF CAPACITY CONSTRAINTS; RELIANCE ON INTERNALLY DEVELOPED SYSTEMS; SYSTEM DEVELOPMENT RISKS

A key element of our strategy is to generate a high volume of traffic on, and use of, our online store. Accordingly, the satisfactory performance, reliability and availability of the online store, transaction-processing systems and network infrastructure are critical to our reputation. These factors are similarly critical to our ability to attract and retain customers and maintain adequate service and customer support levels. Our revenues depend on the number of visitors who shop at our online store and the volume of orders we fulfill. Any system interruptions that cause our online store to be unavailable or impair order fulfillment performance would reduce the volume of goods sold and the attractiveness of our product and service offerings. We have experienced periodic system interruptions, which we believe will continue to occur from time to time. If there is a substantial increase in the volume of traffic on our online store or the number of orders placed by customers we will need to expand and further upgrade our technology, transaction-processing systems and network infrastructure. We may be unable to accurately project the rate or timing of increases, if any, in the use of our online store or timely expand and upgrade our systems and infrastructure to accommodate such increases.

We use an internally developed system, which is supplemented by commercially available licensed technology, for:

- Our online store;

- Search engine; and

- Substantially all aspects of transaction processing, including order management, cash and credit card processing, purchasing, inventory management and shipping.

We intend to upgrade and expand our transaction-processing systems and to integrate newly developed and purchased modules with our existing systems in order to improve our accounting, control and reporting methods and support increased transaction volume. We may be unable to add additional software and hardware or to develop and further upgrade our existing technology, transaction-processing systems or network infrastructure to accommodate increased traffic through our online store or increased sales volume. Any inability to do so may result in:

- Unanticipated system disruptions;

- Slower response times;

- Degradation in levels of customer service;

- Impaired quality and speed of order fulfillment; and

- Delays in reporting accurate financial information.

We may be unable in a timely manner to effectively upgrade and expand our transaction-processing system or to smoothly integrate any newly developed or purchased modules with our existing systems. Any inability to do so could seriously harm our business, financial condition, results of operations, and cash flows.

NEED FOR ADDITIONAL PERSONNEL

Our future success depends on our ability to attract, retain and motivate highly skilled technical, managerial, editorial, merchandising, marketing and customer service personnel. Competition for such personnel is intense, particularly in the San Francisco Bay Area, where our headquarters are located. As a result, we may be unable to successfully attract, assimilate or retain qualified personnel. We have encountered difficulties in attracting a sufficient number of qualified software developers for our online store and transaction-processing systems. Further, we may be unable to retain those developers we currently employ or attract additional developers. The failure to retain and attract the necessary personnel could seriously harm our business, financial condition, results of operations, and cash flows.

FULFILLMENT CENTER RELOCATION

We moved our warehousing and fulfillment of orders to Erlanger, Kentucky in May 1999 in order to be closer to certain publishers, wholesalers, distributors and delivery services. At the same time we moved from a manual distribution process to a software-supported solution from Manhattan Associates, PKMS Warehouse Management System. Relocating such services and moving to an automated distribution process may not result in operating efficiencies or may cause a significant disruption in the fulfillment of orders, the distraction of management and other key personnel and the expenditure of significant financial and other resources. Any such disruption, distraction or expenditure could seriously harm our business, financial condition, results of operations, and cash flows.

SALES AND OTHER TAX COLLECTION

We do not currently collect sales or other similar taxes in respect of shipments of goods into states other than California and Kentucky. However, one or more states or foreign countries may seek to impose sales tax collection obligations on out-of-state or foreign companies which engage in electronic commerce. In addition, any new operations we establish in states outside California and Kentucky could subject shipments into such states to state sales taxes. A successful assertion by one or more states or any foreign country that we should collect sales or other similar taxes on the sale of merchandise could seriously harm our business, financial condition, results of operations, and cash flows.

RISK OF SYSTEM FAILURE; SINGLE SITE AND ORDER INTERFACE

Our success, in particular our ability to successfully receive and fulfill online orders and provide high-quality customer service, largely depends on the efficient and uninterrupted operation of our computer and communications hardware systems. Substantially all of our computer and communications hardware is currently located at a single leased facility in Santa Clara, California. Our systems and operations are vulnerable to damage or interruption from a number of sources, including:

- Fire;

- Flood;

- Power loss;

- Telecommunications failure;

- Break-ins; and

- Earthquake and similar events.

We have experienced minor and infrequent system interruptions in the past. We do not presently have a formal disaster recovery plan and do not carry sufficient business interruption insurance to compensate us for losses that may occur. Despite our implementation of network security measures, our servers are vulnerable to computer viruses, physical or electronic break-ins and similar disruptions. Such disruptions could lead to interruptions, delays,

loss of data or the inability to accept and fulfill customer orders. The occurrence of any of the foregoing risks could seriously harm our business, financial condition, results of operations, and cash flows.

RELIANCE ON CERTAIN SUPPLIERS

For the three and six months ended July 31, 1999, we purchased approximately 35% and 37%, respectively, of our products from Ingram Book Company ("Ingram") and 17% and 18%, respectively, of our products from Pearson Education Division. We rely to a large extent on rapid fulfillment from Ingram and other vendors. We generally have no commitments to or arrangements with any of our vendors that guarantee the availability of merchandise, the continuation of particular payment terms or the extension of credit limits. Our current vendors may not continue to sell merchandise to us on current terms. In addition, we may be unable to establish new or extend current vendor relationships to ensure acquisition of merchandise in a timely and efficient manner and on acceptable commercial terms. If we were unable to develop and maintain relationships with vendors that would allow us to obtain sufficient quantities of merchandise on acceptable commercial terms, our business, financial condition, results of operations, and cash flows would be seriously harmed.

DEPENDENCE ON KEY PERSONNEL

Our performance is substantially dependent on the continued services and on the performance of our senior management and other key personnel. Our performance also depends on our ability to retain and motivate our senior management and other key employees. The loss of the services of any of our executive officers or other key employees could seriously harm our business, financial condition, results of operations, and cash flows.

We have entered into employment agreements with several members of our senior management, including:

- Mr. MacAskill, our President and Chief Executive Officer;

- Mr. Orumchian, our Vice President of Engineering;

- Mr. Alvarez, our Vice President of Finance and Chief Financial Officer; and

- Mr. Cudd, our Vice President of Marketing.

Each employment agreement sets forth the officer's base salary and general employee benefits, including acceleration of a portion of such employee's Common Stock option vesting. We maintain $2.0 million of key person life insurance on Chris MacAskill, our President and Chief Executive Officer.

DEPENDENCE ON CONTINUED GROWTH OF ELECTRONIC COMMERCE

Our future revenues and profits, if any, substantially depend upon the acceptance and use of the Internet and other online services as an effective medium of commerce by our target customers. Rapid growth in the use of and interest in the Internet, the Web and online services is a recent phenomenon. As a result, acceptance and use may not continue to develop at historical rates and a sufficiently broad base of consumers may not adopt, and continue to use, the Internet and other online services as a medium of commerce. Demand and market acceptance for recently introduced services and products over the Internet are subject to a high level of uncertainty and there exist few proven services and products. Our target customer has historically used traditional means of commerce to purchase information resources. For us to be successful, these customers must accept and utilize our online store to satisfy their information resource needs.

In addition, the Internet may not be accepted as a viable long-term commercial marketplace for a number of reasons, including potentially inadequate development of the necessary network infrastructure or delayed development of enabling technologies and performance improvements. To the extent that the Internet continues to experience significant expansion in the number of users, frequency of use or bandwidth requirements, the infrastructure for the Internet may be unable to support the demands placed upon it. In addition, the Internet could lose its viability due to delays in the development or adoption of new standards and protocols required to handle increased levels of Internet activity, or due to increased governmental regulation. Changes in or insufficient availability of telecommunications services to support the Internet also could result in slower response times and adversely affect usage of the Internet generally and Fatbrain.com in particular. Our business, financial condition, results of operations, and cash flows would be seriously harmed if:

- Use of the Internet and other online services does not continue to increase or increases more slowly than expected;

- The infrastructure for the Internet and other online services does not effectively support expansion that may occur; or

- The Internet and other online services do not become a viable commercial marketplace.

RAPID TECHNOLOGICAL CHANGE

To remain competitive, we must continue to enhance and improve the responsiveness, functionality and features of our online operations. The Internet and the electronic commerce industry are characterized by:

- Rapid technological change;

- Changes in user and customer requirements and preferences;

- Frequent new product and service introductions embodying new technologies; and

- The emergence of new industry standards and practices.

The evolving nature of the Internet could render our existing online store and proprietary technology and systems obsolete. Our success will depend, in part, on our ability to:

- License leading technologies useful in our business;

- Enhance our existing services;

- Develop new services and technology that address the increasingly sophisticated and varied needs of our current and prospective customers; and

- Respond to technological advances and emerging industry standards and practices on a cost-effective and timely basis.

The development of our Web site and other proprietary technology entails significant technical and business risks. We may not successfully use new technologies effectively or adapt our online store, proprietary technology and transaction-processing systems to customer requirements or emerging industry standards. If we are unable, for technical, legal, financial or other reasons, to adapt in a timely manner, in response to changing market conditions or customer requirements, our business, financial condition, results of operations, and cash flows could be seriously harmed.

ELECTRONIC COMMERCE SECURITY RISKS

A significant barrier to electronic commerce and communications is the secure transmission of confidential information over public networks. We rely on encryption and authentication technology licensed from third parties to provide the security and authentication necessary for secure transmission of confidential information, such as customer credit card numbers. Advances in computer capabilities, new discoveries in the field of cryptography, or other events or developments may result in a compromise or breach of the algorithms used by us to protect customer transaction data. If any such compromise of our security were to occur, it could seriously harm our reputation, business, financial condition, results of operations, and cash flows. A party who is able to circumvent our security measures could misappropriate proprietary information or cause interruptions in our operations.

We may be required to expend significant capital and other resources to protect against such security breaches or to alleviate problems caused by such breaches. Concerns over the security of the Internet and other online transactions and the privacy of users may also inhibit the growth of the Internet and other online services generally, and the Web in particular, especially as a means of conducting commercial transactions. To the extent that our activities or those of third-party contractors involve the storage and transmission of proprietary information, such as credit card numbers, security breaches could damage our reputation and expose us to a risk of loss or litigation and possible liability. Our security measures may not prevent security breaches and failure to prevent such security breaches may seriously harm our business, financial condition, results of operations, and cash flows.

RISKS ASSOCIATED WITH INTERNATIONAL SALES

For the three and six months ended July 31, 1999, international sales accounted for approximately 14% and 16%, respectively, of our online revenue. We expect that our percentage of online revenue from international markets will continue to represent a significant portion of our total revenue. Our international business activities are subject to a variety of potential risks, including the adoption of laws, political and economic conditions and actions by third parties that would restrict or eliminate our ability to do business in certain jurisdictions. Although we currently transact business in U.S. dollars, to the extent that we determine to transact business in foreign currencies, we will become subject to the risks attendant to transacting in foreign currencies, including potential adverse effects of exchange rate fluctuations.

YEAR 2000 COMPLIANCE

Many currently installed computer systems and software products are coded to accept only two digit entries in the date code field and cannot distinguish dates in the 1900's from dates in the 2000's. This could result in system failures or miscalculations causing disruptions of operations, including, among other things, a temporary inability to process transactions, send invoices or engage in similar normal business activities. As a result, many companies' software and computer systems may need to be upgraded or replaced in order to comply with such "Year 2000" requirements. Although we believe that our products and internal systems are Year 2000 compliant, we utilize third-party equipment and software that may not be Year 2000 compliant. Failure of such third-party equipment or software to operate properly with regard to the Year 2000 and thereafter could require us to incur unanticipated expenses to remedy any problems, which could seriously harm our business, results of operations, financial condition and cash flows.

Any failure to make our products Year 2000 compliant could result in:

- A decrease in sales of our products;

- An increase in the allocation of resources to address Year 2000 problems of our customers without additional revenue commensurate with such dedication of resources; and

- An increase in litigation costs relating to losses suffered by our customers due to such Year 2000 problems.

Furthermore, the purchasing patterns of customers or potential customers may be affected by Year 2000 issues as companies expend significant resources to correct their current systems for Year 2000 compliance. These expenditures may result in reduced funds available to purchase products and services such as those offered by us, which could seriously harm our business, financial condition, results of operations and cash flows. We have conducted a preliminary review of our internal computer systems to identify the systems that could be affected by the Year 2000 issue and to develop a plan to resolve the issue. Based on this preliminary review, we currently have no reason to believe that our internal software systems are not Year 2000 compliant. However, we will continue to evaluate our systems and in the event we conclude that our systems are not Year 2000 compliant, we will develop a contingency plan to address these issues. There can be no assurance that Year 2000 compliance issues will not have a material adverse effect on our business, financial condition, results of operations and cash flows.

TRADEMARKS AND PROPRIETARY RIGHTS; UNLICENSED ARRANGEMENTS AND MATERIALS

We regard our copyrights, service marks, trademarks, trade dress, trade secrets and similar intellectual property as critical to our success. Further, we rely on trademark and copyright law, trade secret protection and confidentiality and license agreements with our employees, customers, partners and others to protect our proprietary rights. We pursue the registration of our trademarks and service marks in the U.S. and internationally, and have applied for the registration of certain of our trademarks and service marks. Effective trademark, service mark, copyright and trade secret protection may not be available in every country in which our products and services are made available online. While we attempt to ensure that the quality of our brand is maintained by such licensees, such licensees may take actions that could seriously harm the value of our proprietary rights or reputation and in turn our business, financial condition, results of operations, and cash flows. The steps we have taken to protect our proprietary rights may not be adequate and third parties may infringe or misappropriate our copyrights, trademarks, trade dress and similar proprietary rights.

In addition, other parties may assert infringement claims against us. Such claims, even if not meritorious, could result in the expenditure of significant financial and managerial resources. We are not currently aware of any legal proceedings pending or threatened against us. In addition, we display reviews and articles on technical subjects in our online store. Some reviews and articles may be copyrighted and we may not have explicit permission from the author for use of such intellectual property. The authors may assert infringement claims against us. If a claim is asserted alleging that we have infringed the proprietary rights of a third party, we may be required to seek licenses to continue to use such intellectual property. The failure to obtain the necessary licenses or other rights at a reasonable cost could seriously harm our business, financial condition, results of operations, and cash flows.

GOVERNMENTAL REGULATION AND LEGAL UNCERTAINTIES

We are not currently subject to direct regulation by any domestic or foreign governmental agency, other than regulations applicable to businesses generally, and laws or regulations directly applicable to access to electronic commerce. However, due to the increasing popularity and use of the Internet, it is possible that a number of laws and regulations may be adopted with respect to the Internet, relating to:

- User privacy;
- Pricing;
- Content;
- Copyrights;
- Distribution; and
- Characteristics and quality of products and services.

Furthermore, the growth and development of the market for electronic commerce may prompt calls for more stringent consumer protection laws that may impose additional burdens on those companies conducting business online. The adoption of any additional laws or regulations may decrease the expansion of the Internet. A decline in the growth of the Internet could decrease demand for our products and services and increase our cost of doing business, or otherwise seriously harm our business, financial condition, results of operations, and cash flows. Moreover, the applicability to the Internet of existing laws in various jurisdictions governing issues such as property ownership, sales tax, libel and personal privacy is uncertain and may take years to resolve. Our business, financial condition, results of operations, and cash flows could be seriously harmed by:

- Any such new legislation or regulation;
- The application of laws and regulations from jurisdictions whose laws do not currently apply to our business; or
- The application of existing laws and regulations to the Internet and other online services.

As our service is offered over the Internet in multiple states and foreign countries, such jurisdictions may claim that we are required to qualify to do business as a foreign corporation in each such state and foreign country. The failure by us to qualify as a foreign corporation in a jurisdiction where it is required to do so could subject us to taxes and penalties for the failure to qualify. It is possible that the governments of other states and foreign countries also might attempt to regulate the content of our online store or prosecute us for violations of their laws. Violations of local laws may be alleged or charged by state or foreign governments. Further, we might unintentionally violate such laws and such laws may be modified and new laws may be enacted in the future.

In addition, several telecommunications carriers are seeking to have telecommunications over the Internet regulated by the Federal Communications Commission (the "FCC") in the same manner as other telecommunications services. The growing popularity and use of the Internet has burdened the existing telecommunications infrastructure and many areas with high Internet use have begun to experience interruptions in phone service. As a result, local exchange carriers have petitioned the FCC to regulate Internet Service Providers ("ISPs") in a manner similar to long distance telephone carriers and to impose access fees on the ISPs. If any effort to increase regulation of ISPs is successful, the expense of communicating on the Internet could increase substantially, potentially slowing the growth in the use of the Internet. Any such new legislation or regulation or application or interpretation of existing laws could seriously harm our business, financial condition, results of operations, and cash flows.

POSSIBLE VOLATILITY OF STOCK PRICE

The trading price of our Common Stock is likely to be highly volatile and could be subject to wide fluctuations in price in response to such factors as:

- Actual or anticipated variations in quarterly operating results;
- Announcements of technological innovations;
- New sales formats or new products or services by us or our competitors;

- Changes in financial estimates by securities analysts;

- Conditions or trends in the Internet and electronic commerce industries;

- Changes in the market valuations of other Internet, online service or retail companies;

- Announcements by us of significant acquisitions, strategic partnerships, joint ventures or capital commitments;

- Additions or departures of key personnel;

- Sales of Common Stock; and

- Other events or factors, many of which are beyond our control.

In addition, the stock market in general, and the Nasdaq National Market and the market for Internet-related and technology companies in particular, has experienced extreme price and volume fluctuations that have often been unrelated or disproportionate to the operating performance of such companies. The trading prices of many technology companies' stocks are at or near historical highs and reflect price earnings ratios substantially above historical levels. These trading prices and price earnings ratios may not be sustained. These broad market and industry factors may seriously harm the market price of the Common Stock, regardless of our operating performance. In the past, following periods of volatility in the market price of a company's securities, securities class-action litigation has often been instituted against such company. Such litigation, if instituted, could result in substantial costs and a diversion of management's attention and resources, which would seriously harm our business, financial condition, results of operations, and cash flows.

ANTI-TAKEOVER EFFECT OF CERTAIN CHARTER PROVISIONS AND DELAWARE LAW

Our Board of Directors has the authority to issue up to 5,000,000 shares of Preferred Stock and to determine the price, rights, preferences, privileges and restrictions, including voting rights, of those shares without any further vote or action by the stockholders. The rights of the holders of Common Stock will be subject to, and may be seriously harmed by, the rights of the holders of any Preferred Stock that may be issued in the future. The issuance of Preferred Stock may have the effect of delaying, deferring or preventing a change in control of the Company without further action by the stockholders and may seriously harm the voting and other rights of the holders of Common Stock. We have no present plans to issue shares of Preferred Stock. Further, certain provisions of our Second Amended and Restated Certificate of Incorporation and Delaware law could delay or make more difficult a merger, tender offer or proxy contest involving the Company.

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PART II. OTHER INFORMATION

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ITEM 1. LEGAL PROCEEDINGS.

None

ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS.

Not applicable

ITEM 3. DEFAULTS UPON SENIOR SECURITIES.

Not applicable

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.

The Company's annual meeting of stockholders was held on June 29, 1999 in Santa Clara, California. Of the 11,109,210 shares outstanding as of the record date, 9,049,046 shares were present or represented by proxy at the meeting. The following matters were submitted to a vote of security holders:

1. The following nominees were elected as directors, each to hold office until his successor is elected and qualified, by the vote set forth below:
</TABLE>

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Nominee	For	Withheld
Chris MacAskill	9,030,528	18,518
Kim Orumchian	9,030,528	18,518
Peter G. Bodine	9,030,528	18,518
Alan S. Fisher	9,030,528	18,518
Tod H. Francis	9,030,528	18,518
David C. Schwab	9,030,528	18,518
Peter C. Wendell	9,030,528	18,518

2. Ratification of the appointment of Deloitte & Touche, LLP, as independent accountants of the Company for the fiscal year ended January 31, 2000:

For	Opposed	Abstained
9,032,478	3,338	13,230

ITEM 5. OTHER INFORMATION.

Not applicable

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K.

(a) The following exhibit is filed as part of this report:

27.01 - Financial Data Schedule

(b) Reports on Form 8-K

No Reports on Form 8-K were filed during the three months ended July 31, 1999.

SIGNATURES

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

September 10, 1999

FATBRAIN.COM, INC.
(Registrant)

By: /s/ Donald P. Alvarez

Donald P. Alvarez
Vice President of Finance and Administration and Chief Financial Officer (Duly Authorized Officer and Principal Financial Officer)

EXHIBIT INDEX

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No.	Description
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27.01	Financial Data Schedule

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