SHUTTERFLY INC
Form 10-Q
October 31, 2008

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549
Form 10-Q

(Mark One)

x	QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 For the quarterly period ended September 30, 2008
	or
o	TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 For the transition period from to

Commission file number 001-33031

SHUTTERFLY, INC.
(Exact Name of Registrant as Specified in Its Charter)

Delaware (State or Other Jurisdiction of Incorporation or Organization)	94-3330068 (IRS Employer Identification No.)
2800 Bridge Parkway, Suite 101 Redwood City, California (Address of Principal Executive Offices)	94065 (Zip Code)

Registrant's Telephone Number, Including Area Code
(650) 610-5200

Indicate by check mark whether the Registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No o

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definition of "accelerated filer," "large accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated Filer o	Accelerated Filer x
Non-accelerated Filer o (Do not check if a smaller reporting company)	Smaller reporting company o

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No x

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Class	Outstanding at October 24, 2008
Common stock, $0.0001 par value per share	25,072,312 shares

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PART I — FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

Item 1. Condensed Consolidated Financial Statements

SHUTTERFLY, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, except par value amounts)
(Unaudited)

	September 30, 2008	December 31, 2007
ASSETS		
Current assets:		
Cash and cash equivalents	$ 40,635	$ 122,582
Short-term investments	-	3,002
Accounts receivable, net	3,144	4,480
Inventories	3,271	4,788
Deferred tax asset, current portion	597	1,677
Prepaid expenses and other current assets	8,063	4,510
Total current assets	55,710	141,039
Long-term investments	47,420	-
Property and equipment, net	51,830	48,416
Goodwill and intangible assets, net	14,632	3,859
Deferred tax asset, net of current portion	23,792	13,294
Other assets	1,821	2,162
Total assets	$ 195,205	$ 208,770
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 6,026	$ 8,783
Accrued liabilities	12,654	18,724
Deferred revenue	9,167	8,699
Current portion of capital lease obligations	514	808
Total current liabilities	28,361	37,014
Other liabilities	1,093	1,083
Capital lease obligations, less current portion	22	107
Total liabilities	29,476	38,204
Commitments and contingencies (Note 7)		
Stockholders' equity		
Undesignated preferred stock, $0.0001 par value; 5,000 shares authorized;		
no shares issued and outstanding	-	-
Common stock, $0.0001 par value; 100,000 shares authorized; 25,071 and		

24,805 shares issued and outstanding on September 30, 2008 and				
December 31, 2007, respectively		2		2
Additional paid-in-capital		199,478		190,849
Accumulated other comprehensive loss		(3,139)		(12)
Deferred stock-based compensation		-		(28)
Accumulated deficit		(30,612)		(20,245)
Total stockholders' equity		165,729		170,566
Total liabilities and stockholders' equity	$	195,205	$	208,770

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

SHUTTERFLY, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share amounts)
(Unaudited)

	Three Months Ended September 30, 2008	Three Months Ended September 30, 2007	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007
Net revenues	$ 35,953	$ 32,602	$ 105,738	$ 89,184
Cost of net revenues (1)	18,430	17,240	53,739	45,107
Gross profit	17,523	15,362	51,999	44,077
Operating expenses (1):				
Technology and development	9,645	7,579	28,642	20,034
Sales and marketing	10,087	7,042	26,762	19,421
General and administrative	6,772	7,352	21,946	20,056
Total operating expenses	26,504	21,973	77,350	59,511
Loss from operations	(8,981)	(6,611)	(25,351)	(15,434)
Interest expense	(100)	(54)	(185)	(147)
Interest income	455	1,350	2,514	4,252
Loss before income taxes	(8,626)	(5,315)	(23,022)	(11,329)
Benefit from income taxes	5,915	2,001	12,655	4,515
Net loss	$ (2,711)	$ (3,314)	$ (10,367)	$ (6,814)
Net loss per share - basic and diluted	$ (0.11)	$ (0.14)	$ (0.41)	$ (0.28)
Weighted-average shares outstanding - basic and diluted	25,067	24,425	25,020	24,165
(1) Stock-based compensation is allocated as follows:				
Cost of net revenues	$ 88	$ 46	$ 263	$ 123
Technology and development	610	162	1,539	618
Sales and marketing	645	267	1,559	580
General and administrative	1,087	549	2,974	1,487

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

SHUTTERFLY, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007
Cash flows from operating activities:		
Net loss	$ (10,367)	$ (6,814)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	17,463	12,217
Amortization of intangible assets	1,370	217
Stock-based compensation, net of cancellations	6,335	2,808
Loss on disposal property and equipment	308	230
Deferred income taxes	(9,746)	(4,547)
Changes in operating assets and liabilities:		
Accounts receivable, net	1,336	488
Inventories	1,518	(542)
Prepaid expenses and other current assets	(3,553)	(936)
Other assets	352	(1,677)
Accounts payable	(2,757)	(1,867)
Accrued and other liabilities	(6,087)	6,931
Deferred revenue	468	1,096
Net cash (used in) provided by operating activities	(3,360)	7,604
Cash flows from investing activities:		
Purchases of property and equipment	(16,760)	(28,501)
Capitalization of software and website development costs	(3,239)	(2,417)
Acquisition of business and intangibles, net of cash acquired	(10,098)	(2,655)
Proceeds from sale of equipment	6	-
Proceeds from sale of short-term investments	3,002	(3,002)
Purchase of auction rate securities	(52,250)	-
Net cash used in investing activities	(79,339)	(36,575)
Cash flows from financing activities:		
Principal payments of capital lease obligations	(378)	(1,871)
Proceeds from issuance of common stock upon exercise of stock options	1,130	3,390
Net cash provided by financing activities	752	1,519
Net decrease in cash and cash equivalents	(81,947)	(27,452)
Cash and cash equivalents, beginning of period	122,582	119,051
Cash and cash equivalents, end of period	$ 40,635	$ 91,599
Supplemental disclosures of cash flow information:		
Cash paid during the period for:		

Interest	$ 38	$ 168
Income taxes	511	760

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

SHUTTERFLY, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 1 — The Company and Summary of Significant Accounting Policies

Shutterfly, Inc., (the “Company”) was incorporated in the state of Delaware in 1999 and began its services in December 1999. The Company is an Internet-based social expression and personal publishing service that enables customers to share, print and preserve their memories by leveraging a technology-based platform and manufacturing processes. The Company provides customers a full range of products and services to organize and archive digital images; share pictures; order prints and create an assortment of personalized items such as cards, calendars and photo books. The Company is headquartered in Redwood City, California.

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and, accordingly, do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. The accompanying unaudited condensed consolidated financial statements include the accounts of Shutterfly, Inc. and its wholly owned subsidiaries. In the opinion of management, all adjustments considered necessary for a fair statement of the Company’s results of operations for the interim periods reported and of its financial condition as of the date of the interim balance sheet have been included. Operating results for the nine months ended September 30, 2008, are not necessarily indicative of the results that may be expected for the year ending December 31, 2008, or for any other period.

The year-end condensed consolidated balance sheet data was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America. These unaudited interim condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes for the year ended December 31, 2007, included in the Company’s Annual Report on Form 10-K.

Principles of Consolidation

The accompanying condensed consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All intercompany transactions and balances have been eliminated.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America 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 date of the financial statements as well as the reported amounts of revenues and expenses during the reporting period. Significant items subject to such estimates and assumptions include provision for sales returns, intangible asset valuations and useful lives, excess and obsolete inventories, deferred tax valuation allowance, auction rate securities valuation, stock-based compensation, restructuring and legal contingencies among others. Actual results could differ from these estimates.

Marketable Securities

The Company evaluates declines in fair value of marketable securities in accordance with SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities, and related guidance issued by the FASB and SEC in order to determine the classification of the decline in fair value as “temporary” or “other-than-temporary.” A temporary decline in fair value results in an unrealized loss being recorded in the other comprehensive income (loss) component of stockholders equity. Such an unrealized loss does not affect net income (loss) for the applicable accounting period. An other-than–temporary decline in fair value is recorded as a realized loss in the condensed consolidated statement of operations and reduces net income (loss) for the applicable accounting period. The differentiating factors between these classifications include the length of time and extent to which the market value has been less than cost, the financial condition of the issuer, and the ability and intent of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in market value.

SHUTTERFLY, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Income Taxes

The Company accounts for income taxes under the liability method. Under this method, deferred tax assets and liabilities are determined based on the difference between the financial statement and tax basis of assets and liabilities and net operating loss and credit carryforwards using enacted tax rates in effect for the year in which the differences are expected to reverse. Valuation allowances are established when necessary to reduce deferred tax assets to the amounts expected to be realized.

The Company accounts for uncertain tax positions in accordance with FASB Interpretation No. 48 Accounting for Uncertainty in Income Taxes (“FIN 48”), an interpretation of FASB Statement No. 109 (“SFAS 109”). The application of income tax law is inherently complex. Laws and regulations in this area are voluminous and are often ambiguous. The Company is required to make subjective assumptions and judgments regarding its income tax exposures. Interpretations and guidance surrounding income tax laws and regulations change over time. Accordingly, changes in the Company’s subjective assumptions and judgments can materially affect amounts recognized in the consolidated balance sheets and statements of operations.

The Company’s policy is to recognize interest and/or penalties related to all tax positions in income tax expense. To the extent that accrued interest and penalties do not ultimately become payable, amounts accrued will be reduced and reflected as a reduction of the overall income tax provision in the period that such determination is made.

The Company is subject to taxation in the United States, California, North Carolina, New Jersey, New York, Minnesota, and Arizona. The Company is subject to examination for tax years including and after 2003 for the United States, 2004 for California, and 2007 for the remaining jurisdictions.

Comprehensive Loss

Comprehensive loss consists of certain changes in equity that are excluded from net loss. Specifically, unrealized gains and losses on available for sale marketable securities are included in accumulated other comprehensive loss.

The components of accumulated other comprehensive loss was as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Unrealized loss in investments, net of tax	$ (904)	$ (20)	$ (3,127)	$ (2)
Net loss	(2,711)	(3,314)	(10,367)	(6,814)
Total comprehensive loss	$ (3,615)	$ (3,334)	$ (13,494)	$ (6,816)

Unrealized loss in investments for the three months ended September 30, 2008 and 2007 are net of tax benefit of ($487) and ($11) respectively. Unrealized loss in investments for the nine months ended September 30, 2008 and 2007 are net of tax benefit of ($1,684) and ($1) respectively.

Recent Accounting Pronouncements

Effective January 1, 2008, the Company adopted SFAS No. 157, “Fair Value Measurements” (“FAS 157”). In February 2008, the FASB issued a staff position which provides a one year deferral of the effective date of SFAS 157 for all nonfinancial assets and liabilities except for those that were recognized or disclosed in the financial statements at fair value at least annually. Therefore, the Company has adopted the provision of FAS 157 with respect to its financial assets and liabilities only. FAS 157 defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. Fair value is defined under FAS 157 as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. Valuation techniques used to measure fair value under FAS 157 must maximize the use of observable inputs and minimize the use of unobservable inputs. The standard describes a fair value hierarchy based on three input levels, of which the first two are considered observable and the last unobservable, as follows:

Level 1 – Quoted prices in active markets for identical assets or liabilities

Level 2 – Inputs other than Level 1 that are observable, either directly or indirectly, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3 – Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

The adoption of this statement did not have a material impact on the Company’s consolidated results of operations and financial condition (see Note 4).

SHUTTERFLY, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Effective January 1, 2008, the Company adopted FAS No. 159, “The Fair Value Option for Financial Assets and Financial Liabilities” (“FAS 159”) which permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. The Company has not elected to adopt the fair value option under this Statement.

In December 2007, the FASB issued FAS No. 141R, “Business Combinations” (“FAS 141R”) which replaces FAS No. 141 and establishes principles and requirements for how the acquirer of a business recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any non-controlling interest in the acquiree. FAS 141R also provides guidance for recognizing and measuring the goodwill acquired in the business combination and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. This Statement applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. Early adoption of FAS 141R is prohibited. The Company does not expect the adoption of FAS 141R will have a material effect on its financial position and results of operations.

In December 2007, the FASB issued SFAS No. 160, “Non-controlling Interests in Consolidated Financial Statements” (“FAS 160”) which amends ARB 51 to establish accounting and reporting standards for the non-controlling interest in a subsidiary and for the deconsolidation of a subsidiary. It clarifies that a non-controlling interest in a subsidiary is an ownership interest in the consolidated entity that should be reported as equity in the consolidated financial statements. In addition to the amendments to ARB 51, this Statement amends FASB Statement No. 128, Earnings per Share; so that earnings-per-share data will continue to be calculated the same way those data were calculated before this Statement was issued. This Statement is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. The Company does not expect the adoption of FAS 160 will have a material effect on its financial position and results of operations.

In April 2008, the Financial Accounting Standards Board ("FASB") issued FASB Staff Position ("FSP") No. 142-3, "Determination of the Useful Life of Intangible Assets". FSP 142-3 amends the factors an entity should consider in developing renewal or extension assumptions used in determining the useful life or recognized intangible assets under FASB Statement No. 142, "Goodwill and Other Intangible Assets". This new guidance applies prospectively to intangible assets that are acquired individually or with a group of other assets in business combinations and asset acquisitions. FSP 142-3 is effective for financial statements issued for fiscal years and interim periods beginning after December 15, 2008. Early adoption is prohibited. The Company does not expect the adoption of FSP 142-3 will have a material effect on its financial position and results of operations.

Note 2 — Stock-Based Compensation

Stock Option Activity

A summary of the Company’s stock option activity for the nine months ended September 30, 2008, is as follows (in thousands):

	Number of Options Outstanding	Weighted Average Exercise Price	Weighted Average Contractual Term (Years)	Aggregate Intrinsic Value
Balances, December 31, 2007	5,642	$ 13.39		
Granted	338	15.73		
Exercised	(200)	2.96		
Forfeited, cancelled or expired	(89)	15.37		
Balances, March 31, 2008	5,691	$ 13.86	8.2	$ 21,746
Granted	147	13.51		
Exercised	(55)	9.14		
Forfeited, cancelled or expired	(57)	20.88		
Balances, June 30, 2008	5,726	$ 13.83	8.0	$ 13,610
Granted	109	10.86		
Exercised	(6)	5.95		
Forfeited, cancelled or expired	(256)	19.34		
Balances, September 30, 2008	5,573	$ 13.53	7.6	$ 7,183
Options vested and expected to vest at September 30, 2008	5,181	$ 13.09	7.5	$ 7,159
Options vested at September 30, 2008	2,788	$ 9.27	6.7	$ 6,448

During the three months ended September 30, 2008, the Company granted options to purchase an aggregate of 109,000 shares of common stock with an estimated weighted-average grant-date fair value of $4.35 per share. The total intrinsic value of options exercised during the three months ended September 30, 2008 was $24,000. Net cash proceeds from the exercise of stock options were $36,000 for the three months ended September 30, 2008. As permitted by SFAS No. 123R, the Company has deferred the recognition of its excess tax benefit from non-qualified stock option exercises and disqualifying dispositions from incentive stock option exercises. As of September 30, 2008, there were approximately 568,000 shares available for grant under the 2006 Equity Incentive Plan (the “2006 Plan”).

SHUTTERFLY, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Valuation of Stock Options

The Company estimated the fair value of each option award on the date of grant using the Black-Scholes option-pricing model and the assumptions noted in the following table. Expected volatility is based on the historical and implied volatility of a peer group of publicly traded entities. The expected term of options gave consideration to historical exercises, post-vesting cancellations and the options' contractual term. The risk-free rate for the expected term of the option is based on the U.S. Treasury Constant Maturity at the time of grant. The assumptions used to value options granted during the three and nine months ended September 30, 2008 and September 30, 2007, were as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)
Dividend yield	—	—	—	—
Annual risk free rate of return	2.9 %	4.2 %	2.6 %	4.6 %
Expected volatility	48.8 %	44.8 %	50.4 %	42.0 %
Expected term (years)	4.7	4.4	4.4	4.3

Employee stock-based compensation expense recognized in the three months ended September 30, 2008, was calculated based on awards ultimately expected to vest and has been reduced for estimated forfeitures. SFAS No. 123R requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

Restricted Stock Units

In 2008, the Company began granting restricted stock units ("RSU") to its employees under the provisions of the 2006 Plan. The cost of restricted stock units is determined using the fair value of our common stock on the date of grant. RSUs typically vest and become exercisable annually based on either a two year, three year or four year total vesting term. In accordance with Statement of Accounting Standards No. 123R, Share-Based Payment ("FAS 123R"), compensation cost is amortized on a straight-line basis over the requisite service period.

Restricted Stock Unit Activity

A summary of the Company's restricted stock unit activity for the nine months ended September 30, 2008, is as follows (in thousands):

	Number of Units Outstanding	Weighted Average Grant Date Fair Value
Balances, December 31, 2007	—	$ —
Granted	231	19.83

Vested	—		—
Forfeited, cancelled or expired	—		—
Balances, March 31, 2008	231	$	19.83
Granted	512		14.12
Vested	—		—
Forfeited, cancelled or expired	—		—
Balances, June 30, 2008	743	$	15.90
Granted	68		10.00
Vested	—		—
Forfeited, cancelled or expired	(47)		14.19
Balances, September 30, 2008	764	$	15.40

Included in the RSU grants for the nine months ended September 30, 2008 are 98,000 RSUs that had both performance and service vesting criteria ("PBRSU"). The performance condition is tied to the Company's future performance, and the service criteria are consistent with the vesting described in the 2006 Plan. Compensation cost associated with these PBRSUs is recognized based on whether or not satisfaction of the performance criteria is probable. If in the future, situations indicate that the performance criteria are not probable, then no further compensation cost will be recorded and any previous costs will be reversed.

SHUTTERFLY, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Inducement Awards

Included in the stock option and restricted stock unit activity above, in the nine month period ended September 30, 2008, the Company granted inducement stock option awards and restricted stock units to an executive. These inducement grants were approved by the Company's Board of Directors and were not issued under a shareholder approved plan. A total of 129,000 options to purchase common stock and 7,000 restricted stock units were granted under this nonqualified agreement. These grants have a 10 year term, and vest over a four year period from the initial date of hire of the executive, in a manner consistent with awards granted under the 2006 Plan. Included in the three month period ended September 30, 2008 are 50,000 previously issued inducement stock option awards which have been forfeited pursuant to the termination of an executive.

At September 30, 2008, the Company had $27,396,000 of total unrecognized compensation expense under SFAS No. 123R, net of estimated forfeitures, related to stock options and awards that will be recognized over a weighted-average period of approximately two and a half years.

Note 3 — Net Loss Per Share

Basic net loss per share is computed by dividing the net loss attributable to common shares for the period by the weighted average number of common shares outstanding during the period as reduced by the weighted average unvested common shares subject to repurchase by the Company.

Diluted net loss per share is computed by dividing the net loss attributable to common shares for the period by the weighted average number of common and potential common shares outstanding during the period, if the effect of each class of potential common shares is dilutive. Potential common shares include restricted common stock, common stock subject to repurchase rights, and incremental shares of common stock issuable upon the exercise of stock options.

	Three Months Ended September 30, (in thousands)		Nine Months Ended September 30, (in thousands)	
	2008	2007	2008	2007
Historical net loss per share:				
Numerator				
Net loss	$ (2,711)	$ (3,314)	$ (10,367)	$ (6,814)
Denominator				
Weighted-average common shares outstanding	25,067	24,434	25,022	24,182
Less: Weighted-average unvested common shares subject to repurchase	(0)	(9)	(2)	(17)
Denominator for basic net loss per share	25,067	24,425	25,020	24,165
Dilutive effect of stock options, restricted stock units	—	—	—	—

and shares subject to repurchase				
Denominator for diluted net loss per share	25,067	24,425	25,020	24,165
Net loss per share — basic and diluted	$ (0.11)	$ (0.14)	$ (0.41)	$ (0.28)

The following weighted-average outstanding options, common stock subject to repurchase and restricted stock units were excluded from the computation of diluted net loss per common share for the periods presented because including them would have had an anti-dilutive effect:

	Three Months Ended September 30, (in thousands)		Nine Months Ended September 30, (in thousands)	
	2008	2007	2008	2007
Options to purchase common stock, common stock subject to repurchase and restricted stock units	6,443	5,276	6,108	5,248

SHUTTERFLY, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 4 — Fair Value Measurement

In accordance with FAS 157, the following table represents the Company's fair value hierarchy for its financial assets (cash equivalents and available for sale investments) as of September 30, 2008 (in thousands):

	September 30, 2008			
	Fair Value	Level 1	Level 2	Level 3
Cash equivalents:				
Money market funds	$ 34,030	$ 34,030	$ —	$ —
Long-term investments:				
Auction rate securities	47,420	—	—	47,420
Total financial assets	$ 81,450	$ 34,030	$ —	$ 47,420

The Company's non-current auction rate securities make up the majority of the Company's combined financial assets subject to fair value measurement and are the only securities valued under the Level 3 hierarchy. Auction-rate securities ("ARS") are long-term variable rate bonds tied to short-term interest rates. After the initial issuance of the securities, the interest rate on the securities is reset periodically, at intervals established at the time of issuance (primarily every twenty-eight days), based on market demand for a reset period. Auction rate securities are bought and sold in the marketplace through a competitive bidding process often referred to as a "Dutch auction." If there is insufficient interest in the securities at the time of an auction, the auction may not be completed and the rates may be reset to predetermined "penalty" or "maximum" rates.

From the inception of these investments in ARS in January 2008 through September 30, 2008, due to the recent uncertainties in the credit markets, all scheduled auctions have failed. Consequently, the investments are not currently liquid and the Company will not be able to access these funds until a future auction of these investments is successful, the securities are called by the issuer or a buyer is found outside of the auction process. At the time of the initial investment and through the date of this report, all of these auction rate securities remain AAA rated. The assets underlying each security are student loans and 90% of the principal amounts are guaranteed by the Federal Family Education Loan Program ("FFELP"). The Company believes it has the ability and intent to hold these ARS investments until the lack of liquidity in these markets is resolved. As a result, the Company has classified the entire balance of ARS as non-current investments on its condensed consolidated balance sheet.

Typically, the fair value of ARS investments approximates par value due to the frequent resets through the auction process. While the Company continues to earn interest on its ARS investments at the contractual rate, these investments are not currently trading and therefore do not have a readily determinable market value. Accordingly, the estimated fair value of the ARS investments no longer approximates par value.

At September 30, 2008, the Company utilized a discounted cash flow approach to determine the Level 3 valuation for the ARS investments. This analysis indicated a fair value of $47.4 million. The assumptions used in preparing the discounted cash flow model include estimates for interest rates, timing and amount of cash flows, credit and liquidity premiums, and expected holding periods of the ARS. These assumptions are volatile and subject to change as the underlying sources of these assumptions and market conditions change. They represent the Company's estimates given available data as of September 30, 2008. Based on this assessment of fair value, as of September 30, 2008 the Company determined there was a decline in fair value of its ARS investments of $4.8 million which was deemed temporary. That amount has been recorded net of tax, as a component of other comprehensive income. If in the future, the Company concludes that the impairment is other-than-temporary, there would be a charge to the income statement equal to the amount of the unrealized loss at the time that conclusion was made.

The following table provides a summary of changes in fair value of the Company's ARS investments (Level 3) as of September 30, 2008 (in thousands):

Balance at December 31, 2007	$	—
Purchase of ARS investments		52,250
Unrealized loss included in other comprehensive income		(4,830)
Balance at September 30, 2008	$	47,420

SHUTTERFLY, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 5 — Balance Sheet Components

Property and Equipment

	September 30, 2008	December 31, 2007
	(in thousands)	
Computer and other equipment	$ 76,978	$ 66,663
Software	8,526	6,089
Leasehold improvements	8,703	7,952
Furniture and fixtures	2,561	2,282
Capitalized software and website development costs	10,246	6,656
	107,014	89,642
Less: Accumulated depreciation and amortization	(55,184)	(41,226)
Net property and equipment	$ 51,830	$ 48,416

Property and equipment includes $3,356,000 and $5,121,000 of equipment under capital leases at September 30, 2008 and December 31, 2007, respectively. Accumulated depreciation of assets under capital leases totaled $2,893,000 and $3,798,000 at September 30, 2008 and December 31, 2007, respectively.

Depreciation and amortization expense totaled $6,226,000 and $4,749,000 for the three months ended September 30, 2008 and 2007, respectively. Depreciation and amortization expense totaled $17,463,000 and $12,217,000 for the nine months ended September 30, 2008 and 2007, respectively.

As a result of the Company's decision to close its Hayward facility, the Company will accelerate the depreciation of leasehold improvements at the Hayward facility totaling approximately $800,000 as of the announcement date of July 2008, through the closure date in early 2009. For the three months ended September 30, 2008, the Company recorded $158,000 of accelerated depreciation for these leasehold improvements.

Accrued Liabilities

	September 30, 2008	December 31, 2007
	(in thousands)	
Accrued marketing expenses	$ 2,954	$ 4,101
Accrued compensation	2,893	3,053
Accrued purchases and production facility expenses	1,710	4,697
Accrued sales taxes	1,109	3,682
Accrued consultant expenses	1,054	1,516
Accrued other	2,934	1,675
	$ 12,654	$ 18,724

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Note 6 — Restructuring

In July 2008, the Company announced that effective in early 2009, it would close its Hayward production facility and begin operations at a new manufacturing facility to be located in Phoenix, Arizona. As a result of this decision, the Company incurred approximately $80,000 in contractual lease termination costs which was recorded in the second quarter of the fiscal year. The Company will also incur $794,000 in severance costs, which will be recognized ratably over the period from the severance communication date in July 2008, through the facility closure date in early 2009. As of September 30, 2008, the Company has recognized $240,000 in severance costs. The Company expects to incur up to $200,000 in additional costs associated with the relocation of certain employees, which will be expensed as incurred in 2009.

Accrued liabilities related to restructuring actions consist of (in thousands):

	Facility Closure Costs	Workforce Reduction Costs	Total
Balance, December 31, 2007	$ -	$ -	$ -
Restructuring charges	80	240	320
Payments	-	-	-
Balance, September 30, 2008	$ 80	$ 240	$ 320

Note 7 — Commitments and Contingencies

Indemnifications

In the normal course of business, the Company enters into contracts and agreements that contain a variety of representations and warranties and provide for general indemnifications. The Company's exposure under these agreements is unknown because it involves claims that may be made against the Company in the future, but have not yet been made. To date, the Company has not paid any claims or been required to defend any action related to its indemnification obligations. However, the Company may record charges in the future as a result of these indemnification obligations.

Contingencies

From time to time, the Company may have certain contingent liabilities that arise in the ordinary course of its business activities. The Company accrues contingent liabilities when it is probable that future expenditures will be made and such expenditures can be reasonably estimated.

Line of Credit

In April 2008, the Company entered into a line of credit facility (the "Facility") with JPMorgan Chase Bank, N.A. The Facility is a $20.0 million 364-day revolving line of credit, and is collateralized by substantially all of the assets of the Company. The Company will use amounts borrowed under the Facility, if any, to finance the company's working Capital needs and for general corporate purposes, including future acquisitions. As of September 30, 2008, the Company has not drawn on the line of credit. The Company incurred $236,000 of Facility origination costs which have been capitalized within prepaid expenses and will be amortized over the 12 month term of the Facility.

Legal Matters

On or about June 18, 2007, Fotomedia Technologies, LLC filed a lawsuit in the United States District Court for the Eastern District of Texas, against the Company and several other defendants alleging patent infringement. The Fotomedia Complaint seeks unspecified damages, costs, interest and attorneys' fees, and an injunction against all parties. In lieu of answering the Fotomedia Complaint, the Company moved to dismiss it by joining in a motion filed by co-defendant Photobucket.com, Inc. While the motion was pending and not yet decided, on or about November 6, 2007, Fotomedia filed an Amended Complaint. The Amended Complaint likewise alleges infringement of the same three patents and seeks unspecified damages, costs, interest and attorneys' fees, and a permanent injunction. However, the amended complaint dropped the allegations of willful infringement against the Company in connection with one of the patents-at-issue. Defendants moved to dismiss the Amended Complaint as well. The motion was denied by the Court, and the Company subsequently filed an answer to the Amended Complaint on October 8, 2008, as well as counterclaims seeking declarations of non-infringement and invalidity of the patents-in-suit. The Court has set a schedule in this matter, which includes a trial date of November 2, 2009. At this time, the Company does not believe that the amount of potential loss, if any, is reasonably estimable.

On or about February 5, 2008, Parallel Networks, LLC filed a lawsuit in the United States District Court for the Eastern District of Texas, against the Company and several other defendants alleging patent infringement. The Parallel Networks Complaint seeks unspecified damages, costs, interest and attorneys' fees, and an injunction against all parties. The Company filed an answer to the complaint on April 29, 2008. Plaintiff has moved to consolidate this case with an earlier case filed against Netflix, Inc., et al., which the Company has opposed. A hearing on this motion is set for November 6, 2008. In addition, the Company has joined a motion to stay the litigation based on pending reexaminations of the patents-in-suit filed in the U.S. Patent & Trademark Office. A hearing on this motion is also set for November 6, 2008. The Court has set a schedule in this matter, which includes a trial date of March 2, 2010. At this time, the Company does not believe that the amount of potential loss, if any, is reasonably estimable.

From time to time, the Company may be involved in various legal proceedings arising in the ordinary course of business. At September 30, 2008, in the opinion of management, there are no other matters that are expected to have a material adverse effect on the Company's financial position, results of operations or cash flows.

Note 8 — Acquisition

Nexo Systems, Inc .. On January 4, 2008, the Company acquired all of the outstanding shares of Nexo Systems, Inc. ("Nexo") for total aggregate cash purchase price of $10.1 million, including $0.1 million in fees; and $4.0 million in restricted stock. Nexo has developed and launched an internet-based platform, whereby groups can create customized, content-rich personal and group websites. The acquisition was accounted for as a non-taxable purchase transaction and, accordingly, the purchase price has been allocated to the tangible assets, liabilities assumed, and identifiable intangible assets acquired based on their estimated fair values on the acquisition date. The excess of the purchase price over the aggregate fair values was recorded as goodwill. The restricted stock award was granted to the Nexo founders contingent upon their continued employment for a period of two years. As a result, the $4.0 million will be recognized as stock-based compensation over the two year service period.

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The total purchase price of $5.1 million was allocated to developed technology and is being amortized over an estimated useful life of five years, and $0.1 million was allocated to all other assets and liabilities acquired. No amount was allocated to in-process research and development. The remaining excess purchase price of approximately $4.9 million was allocated to goodwill. In addition, $2.0 million was recorded as a deferred tax liability representing the difference between the assigned values of the assets acquired and the tax basis of those assets, with the offset recorded as additional goodwill. The results of operations for the acquired business have been included in the condensed consolidated statement of operations for the period subsequent to our acquisition of Nexo. Nexo's results of operations for periods prior to this acquisition were not material to the condensed consolidated statement of operations and, accordingly, pro forma financial information has not been presented.

The following table provides a summary of the activity of the Company’s goodwill and intangible asset balances due to the additions from the Nexo acquisition (in thousands):

	December 31, 2007	Additions	Accumulated Amortization	September 30, 2008
Purchase technology	$ 3,350	$ 5,100	$ (1,965)	$ 6,485
Customer relationships	990	-	(357)	633
Licenses and other	186	70	(94)	162
Total intangible assets, net	$ 4,526	$ 5,170	$ (2,416)	$ 7,280
Goodwill	$ 379	$ 6,973	-	$ 7,352

Note 9 — Intellectual Property Cross-Licensing Agreement

On September 17, 2008, the Company entered into a multi-million dollar cross-licensing agreement for intellectual property with a digital imaging company. Under the terms of the agreement, the digital imaging company has rights to use the Company’s current and pending patented technology and processes. In addition, the Company has rights to use certain of the digital imaging company’s pending patented technology and processes.

As consideration for the rights under the agreement, the digital imaging company will pay fees due under the agreement in two installments of which the first installment was paid in September 2008 and the remaining installment is due in September 2009. Such amounts are and will be recognized as a reduction of general and administrative expense as each installment becomes due and payable.

On February 8, 2008, the Company entered into a multi-million dollar cross-licensing agreement for intellectual property with American Greetings, Inc (“AGI”). Under the terms of the agreement, AGI has rights to use the Company’s current and pending patented technology and processes. In addition, the Company has rights to use certain of AGI’s current and pending patented technology and processes.

As consideration for the rights under the agreement, AGI will pay fees due under the agreement in three installments of which the first installment was paid in February 2008 and the remaining two installments are due in March 2009, and March 2010. Such amounts will be recognized as a reduction of general and administrative expense as each installment becomes due and payable.

Note 10 — Subsequent Event

In October 2008, the Company received an offer (the "Offer") from UBS AG ("UBS"). As a UBS client who holds Auction Rate Securities ("ARS"), if the Company accepts the Offer it will receive ARS Rights, which will entitle the Company to sell ARS to USB affiliates during the period from June 30, 2010 to July 2, 2012 for a price equal to par value. In exchange for the issuance of the ARS Rights, the UBS affiliates will have the discretionary right to sell the Company's eligible ARS on the Company's behalf, without prior notification, at any time before the expiration of the related ARS Right, so long as the Company receives par value for the sold ARS. The Offer is non-transferable and expires on November 14, 2008. The Company is currently evaluating the Offer and its potential financial statement impact.

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

CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

This document, including the following Management’s Discussion and Analysis of Financial Condition and Results of Operations, contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934 that are based upon our current expectations. These forward-looking statements include statements related to our expectations regarding the seasonality of our business, the decline in average selling prices for prints, revenue trends, average order value, number of orders, number of customers, operating expenses as a percentage of net revenues, the effect of capital expenditures on our results of operations , effective tax rates, realization of deferred tax assets, the sufficiency of our cash and cash equivalents balances and cash generated from operations for the next 12 months and our ability to grow our personalized products and services as a percentage of our total revenues, as well as other statements regarding our future operations, financial condition and prospects and business strategies. In some cases, you can identify forward-looking statements by terminology such as “project,” “believe,” “anticipate,” “plan,” “expect,” “estimate,” “intend,” “continue,” “should,” “w “potentially,” “will,” or “may,” or the negative of these terms or other comparable terminology. Forward-looking statements involve risks and uncertainties. Our actual results and the timing of events could differ materially from those anticipated in our forward-looking statements as a result of many factors, including but not limited to, the seasonality of our business, whether we are able to expand our customer base and increase our product and service offering, competition in our marketplace and the other risks set forth below under “Risk Factors” in Part II, Item 1A of this report. Given these risks and uncertainties, readers are cautioned not to place undue reliance on such forward-looking statements. We assume no obligation to update any of the forward-looking statements after the date of this report or to conform these forward-looking statements to actual results.

Overview

We are an Internet-based social expression and personal publishing service that enables consumers to share, print and preserve their memories by leveraging our technology, manufacturing, web-design and merchandising capabilities. Our primary focus is on helping consumers manage their memories through the powerful medium of photos. We provide a full range of personalized photo-based products and services that make it easy, convenient and fun for consumers to upload, edit, enhance, organize, find, share, create, print and preserve their memories in a creative and thoughtful manner.

Consumers use our products and services to stay connected to their friends and family, to organize their memories in a single location, to tell stories and to preserve their memories for themselves and their children. Our customers purchase physical products both for their own personal use and for giving thoughtful and personalized gifts such as photo books, calendars, greeting cards and other photo-based products and merchandise.

We currently generate the majority of our revenues by producing and selling professionally-bound photo books, personalized calendars, greeting cards, other photo-based merchandise and high-quality prints (ranging in size from wallet-sized to jumbo-sized 20×30 enlargements). We manufacture these items in our Hayward, California and Charlotte, North Carolina manufacturing facilities. In July 2008, we announced that we will be closing our Hayward, California production facility in early 2009 and expect to begin ramping up operations in a new manufacturing and production facility in Phoenix, Arizona. By controlling the production process in our own manufacturing facilities, we are able to produce high-quality products, innovate rapidly, maintain a favorable cost structure and ensure timely shipment to customers, even during peak periods of demand. Additionally, we sell a variety of photo-based merchandise that is currently manufactured for us by third parties, such as mugs, mouse pads, coasters, tote bags, desk organizers, puzzles, playing cards, multi-media DVDs, magnets and keepsake boxes, and ancillary products, such as frames, photo albums and scrapbooking accessories. In the future, we plan to increase the outsourced manufacturing of certain additional components of our product line.

Our high-quality products and services and the compelling online experience we create for our customers, together with our focus on continuous innovation, have earned us numerous third-party accolades and, more importantly, have allowed us to establish a premium brand. We believe that we realize the benefits of a premium brand through high customer loyalty, low customer acquisition costs and premium pricing.

Our customers are a central part of our business model. They generate most of the content on our service by uploading their photos and storing their memories. In addition, they share their photos electronically with their friends and families, extending and endorsing our brand and creating a sense of community. Finally, by giving Shutterfly-branded products to colleagues, friends and loved ones throughout the year, customers reinforce the Shutterfly brand. Through these various activities, our customers create a viral network of new users and customers.

In addition to driving lower customer acquisition costs through viral marketing, our customers provide input on new features, functionalities and products. Close, frequent customer interactions, coupled with significant investments in sophisticated integrated marketing programs, enable us to fine-tune and tailor our promotions and website presentation to specific customer segments. Consequently, customers are presented with a highly personalized Shutterfly shopping experience, which helps foster a unique and deep relationship with our brand.

Our corporation was formed in 1999 and we have experienced rapid growth since launching our service in December 1999. During the three months ended September 30, 2008, we fulfilled more than 1.6 million orders, to approximately 916,000 customers, at an average order value of more than $21 per order.

On January 4, 2008, for approximately $10.1 million in cash and stock consideration of approximately $4.0 million, we acquired Nexo, a privately held on-line sharing and group services company based in Palo Alto, California.

Basis of Presentation

Net Revenues. We generate revenues primarily from the printing and shipping of photo-based products, such as photo books, cards and calendars, photo prints, photo-based merchandise, such as mugs, mouse pads and magnets, and ancillary products such as frames, photo albums and scrapbooking accessories. Revenues are recorded net of estimated returns, promotions redeemed by customers and other discounts. Customers place orders through our website and pay primarily using credit cards.

Our personalized products and services revenues are derived from the sale of photo-based products, photo-based merchandise and ancillary products and services, and the related shipping revenues. Referral fees are also included in personalized products and services revenue. We believe our products and services are differentiated from other traditional photo processors by our high quality production and numerous form factors and templates, which are key to attracting and retaining customers.

Our business is subject to seasonal fluctuations. In particular, we generate a substantial portion of our revenues during the holiday season in the calendar fourth quarter. We also typically experience increases in net revenues during other shopping-related seasonal events, such as Easter, Mother’s Day, Father’s Day, and Halloween. We generally experience lower net revenues during the first, second and third calendar quarters and, as is typical in the retail industry, have incurred and may continue to incur losses in these quarters. Due to the relatively short lead time required to fulfill product orders, usually one to three business days, order backlog is not material to our business.

To further understand revenue trends, we monitor several key metrics including:

Total Customers. We closely monitor total customers as a key indicator of demand. Total customers include the number of transacting customers in a given period. We seek to expand our customer base by empowering our existing customers with sharing and collaboration services (such as Shutterfly Gallery and Shutterfly Share), and by conducting integrated marketing and advertising programs. Total customers have increased on an annual basis each year since inception, and we anticipate that this trend will continue.

Average Order Value. Average order value is net revenues for a given period divided by the total number of customer orders recorded during that same period. We seek to increase average order value as a means of increasing net revenues. Average order value has increased on an annual basis for each year since 2000, and we anticipate that this trend will continue in the future.

Total Number of Orders. We closely monitor total number of orders as a leading indicator of net revenue trends. We recognize the net revenues associated with an order when the products have been shipped and all other revenue recognition criteria have been met. Orders are typically processed and shipped within two business days after a customer places an order. Total number of orders has increased on an annual basis for each year since 2000, and we anticipate that this trend will continue in the future.

Personalized Products and Services Revenues as Percentage of Net Revenues. We continue to innovate and improve our personalized products and services and expect the net revenues from these products and services to increase as percentage of net revenues as we continue to diversify our product offerings. Personalized products and services as a percentage of total net revenue increased from 51% in 2006 to 56% in 2007. In addition, as a percentage of total net revenues, revenues from 4x6 prints have been declining; from 37% in 2005, to 28% in 2006, and to 22% in 2007.

We believe the analysis of these metrics provides us with important information on our overall net revenue trends and operating results. Fluctuations in these metrics are not unusual and no single factor is determinative of our net revenues and operating results.

Cost of Net Revenues. Cost of net revenues consist primarily of direct materials (the majority of which consists of paper, ink, and photo book covers), payroll and related expenses for direct labor, shipping charges, packaging supplies, distribution and fulfillment activities, rent for production facilities, depreciation of production equipment, and third-party costs for photo-based merchandise. Cost of net revenues also includes payroll and related expenses for personnel engaged in customer service. In addition, cost of revenues includes any third-party software or patents licensed, as well as the amortization of acquired developed technology and capitalized website development costs. Beginning in July 2008, costs of net revenues also include certain costs associated with the closure of our Hayward manufacturing and production facility.

Operating Expenses. Operating expenses consist of technology and development, sales and marketing, and general and administrative expenses. We anticipate that each of the following categories of operating expenses will increase in absolute dollar amounts, but remain relatively consistent as a percentage of net revenues.

Technology and development expense consists primarily of personnel and related costs for employees and contractors engaged in the development and ongoing maintenance of our website, infrastructure and software. These expenses include depreciation of the computer and network hardware used to run our website and store the customer data, as well as amortization of purchased software. Technology and development expense also includes co-location and bandwidth costs.

Sales and marketing expense consists of costs incurred for marketing programs and personnel and related expenses for our customer acquisition, product marketing, business development and public relations activities. Our marketing efforts consist of various online and offline media programs, such as e-mail and direct mail promotions, the purchase of keyword search terms and various strategic alliances. We depend on these efforts to attract customers to our service.

General and administrative expense includes general corporate costs, including rent for our corporate offices, insurance, depreciation on information technology equipment and legal and accounting fees. In addition, general and administrative expense includes personnel expenses of employees involved in executive, finance, accounting, human resources, information technology and legal roles. Third-party payment processor and credit card fees are also included in general and administrative expense and have historically fluctuated based on revenues during the period. To date, all of the payments we have received from our intellectual property license agreements have been included as an offset to general and administrative expense.

Interest Expense. Interest expense consists of interest costs recognized under our capital lease obligations and other borrowings as well as costs associated with our working capital line of credit.

Interest Income. Interest income consists of the interest earned on our cash and investment accounts.

Income Taxes . Historically, we have only been subject to taxation in the United States because we only operate within the United States. We expect our full year 2008 effective tax rate to range from 22% to 50%.

Critical Accounting Policies and Estimates

Our consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States, or GAAP. The preparation of these consolidated financial statements requires us to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, costs and expenses and related disclosures. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances. In many instances, we could have reasonably used different accounting estimates, and in other instances, changes in the accounting estimates are reasonably likely to occur from period to period. Accordingly, actual results could differ significantly from the estimates made by our management. To the extent that there are material differences between these estimates and actual results, our future financial statement presentation of our financial condition or results of operations will be affected.

In many cases, the accounting treatment of a particular transaction is specifically dictated by GAAP and does not require management’s judgment in its application, while in other cases, management’s judgment is required in selecting among available alternative accounting standards that allow different accounting treatment for similar transactions. We believe that the accounting policies discussed below are the most critical to understanding our historical and future performance, as these policies relate to the more significant areas involving management’s judgments and estimates.

Revenue Recognition. We generate revenues primarily from the printing and shipping of prints and other photo-based products, and referral fees. We generally recognize revenues from product sales upon shipment when persuasive evidence of an arrangement exists (typically through the use of a credit card or receipt of a check), the selling price is fixed or determinable and collection of resulting receivables is reasonably assured. Revenues from amounts billed to customers, including prepaid orders, are deferred until shipment of fulfilled orders. We provide our customers with a 100% satisfaction guarantee whereby products can be returned within a 30-day period for a reprint or refund. We maintain an allowance for estimated future returns based on historical data. During the nine month period ended September 30, 2008, returns totaled less than 1% of net revenues and have been within management’s expectations. We periodically provide incentive offers to our customers in exchange for setting up an account and to encourage purchases. Such offers include free products and percentage discounts on current purchases. Discounts, when accepted by customers, are treated as a reduction to the purchase price of the related transaction and are included in net revenues. Production costs related to free products are included in costs of revenues upon redemption. Shipping charged to customers is recognized as revenue at the time of shipment. Revenue from referral fees for click-throughs is recognized in the period that the click-through impression is delivered.

Inventories. Our inventories consist primarily of paper, photo book covers and packaging supplies and are stated at the lower of cost on a first-in, first-out basis or net realizable value. The value of inventories is reduced by an estimate for excess and obsolete inventories. The estimate for excess and obsolete inventories is based upon management’s review of utilization of inventories in light of projected sales, current market conditions and market trends.

Software and Website Development Costs. We capitalize eligible costs associated with software developed or obtained for internal use in accordance with the AICPA Statement of Position No. 98-1 "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use" and EITF Issue No. 00-2 "Revenue Arrangements with Multiple Deliverables". Accordingly, payroll and payroll-related costs, including stock based compensation, incurred in the development phase are capitalized and amortized over the product’s estimated useful life, which is generally three years. Costs associated with minor enhancements and maintenance for our website are expensed as incurred.

Income Taxes. We use the asset and liability method of accounting for income taxes. Under this method, deferred tax assets and liabilities are recognized by applying the statutory tax rates in effect in the years in which the differences between the financial reporting and tax filing bases of existing assets and liabilities are expected to reverse. We have considered future taxable income and ongoing prudent and feasible tax planning strategies in assessing the need for a valuation allowance against our deferred tax assets. We believe that all net deferred tax assets shown on our balance sheet are more likely than not to be realized in the future and no valuation allowance is necessary. In the event that actual results differ from those estimates or we adjust those estimates in future periods, we may need to record a valuation allowance, which will impact deferred tax assets and the results of operations in the period the change in made.

Stock-based Compensation Expense. On January 1, 2006, we adopted FAS 123(R), which requires a fair value measurement and recognition of compensation expense for all share-based payment awards made to our employees and directors, including employee stock options and restricted stock awards.

Under SFAS No 123R, we estimate the fair value of stock options granted using the Black-Scholes valuation model. This model requires us to make estimates and assumptions including, among other things, estimates regarding the length of time an employee will retain vested stock options before exercising them, the estimated volatility of our common stock price and the number of options that will be forfeited prior to vesting. The fair value is then amortized on a straight-line basis over the requisite service periods of the awards, which is generally the vesting period. Changes in these estimates and assumptions can materially affect the determination of the fair value of stock-based compensation and consequently, the related amount recognized in our consolidated statements of operations.

The cost of restricted stock awards and performance based restricted stock awards is determined using the fair value of our common stock on the date of grant. Compensation expense is recognized for restricted stock awards on a straight-line basis over the vesting period. Compensation expense associated with performance based restricted stock awards is recognized based on whether or not satisfaction of the performance criteria is probable. If in the future, situations indicate that the performance criteria are not probable, then no further compensation cost will be recorded, and any previous costs will be reversed.

Results of Operations

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Net revenues	100%	100%	100%	100%
Cost of revenues	51%	53%	51%	51%
Gross profit	49%	47%	49%	49%
Operating expenses:				
Technology and development	27%	23%	27%	22%
Sales and marketing	28%	22%	25%	22%
General and administrative	19%	23%	21%	22%
Loss from operations	(25)%	(21)%	(24)%	(17)%
Interest expense	0%	0%	0%	0%
Other income (expense), net	1%	4%	2%	5%
Loss before income taxes	(24)%	(17)%	(22)%	(12)%
Benefit from income taxes	16%	6%	12%	5%
Net loss	(8)%	(11)%	(10)%	(7)%

Comparison of the Three and Nine Month Periods Ended September 30, 2008 and 2007

	Three Months Ended September 30,			Nine Months Ended September 30,		
	2008	2007	% Change	2008	2007	% Change
	(in thousands)			(in thousands)		
Net revenues	$ 35,953	$ 32,602	10%	$ 105,738	$ 89,184	19%
Cost of net revenues	18,430	17,240	7%	53,739	45,107	19%
Percentage of net revenues	51%	53%		51%	51%	

Net revenues increased $3.4 million, or 10%, for the three months ended September 30, 2008, as compared to the same period in 2007. Net revenues increased $16.6 million, or 19% for the nine months ended September 30, 2008, as compared to the same period in 2007. Revenue growth was attributable to the increases in both print and personalized products and services revenues. Personalized products and services revenues (“PPS”) increased $4.8 million, or 32%, to $19.4 million for the three months ended September 30, 2008 as compared to the same period in 2007. PPS increased $14.1 million, or 33%, to $57.5 million for the nine months ended September 30, 2008 as compared to the same period in 2007. This change was primarily the result of increased sales of photo books and greeting cards, as well as an increase in referral fees. PPS made up 54% of net revenues for the three months ended September 30, 2008, up from 45% for the same period in 2007. PPS made up 54% of net revenues for the nine months ended September 30, 2008, up from 49% for the same period in 2007. Print revenues decreased $1.4 million, or 8%, to $16.6 million for the three months ended September 30, 2008 as compared to the same period in 2007. Print revenues increased $2.5 million, or 5%, to $48.3 million for the nine months ended September 30, 2008 as compared to the same period in 2007. During the third quarter of 2008, we made a permanent price adjustment on 4x6 prints, lowering the list price from $0.19 to $0.15 and we also reduced the lowest tier in our prepaid plan to $0.10. Net revenue increases were also the result of year-over-year increases in customers and average order value (“AOV”), while total orders were flat. Average order value improvement was a result of a continued mix shift from prints to higher value personalized products particularly on photo books.

	Three Months Ended September 30,			
	2008	2007	Change	% Change
	(In thousands, except AOV amounts)			
Customers	916	844	72	9%
Orders	1,656	1,661	(5)	--
Average order value	$ 21.71	$ 19.63	$ 2.08	11%

Cost of net revenues increased $1.2 million, or 7%, for the three months ended September 30, 2008 as compared to the same period in 2007. As a percentage of net revenues, cost of net revenues decreased from 53% to 51% for the same comparable period, which increased gross margin from 47% in the third quarter of 2007 to 49% in the third quarter of 2008. Improvement in margin is primarily a result of continued labor efficiencies from our Charlotte plant, improvements in both material and shipping costs and reduced costs for equipment rentals. Cost of net revenues increased $8.6 million, or 19%, for the nine months ended September 30, 2008 as compared to the same period in 2007. As a percentage of net revenues, cost of net revenues remained flat at 51% for the same comparable period, as did gross margin at 49% in the first three quarters of 2007 and the first three quarters of 2008. Overall, the increase in cost of net revenues was primarily the result of the increased volume of shipped products, fixed costs associated with operating two manufacturing facilities in the first two quarters of 2008 versus one facility in 2007, and the impact of intangible amortization from the Nexo acquisition which was not included in the nine months ended September 30, 2007. In addition, we incurred approximately $0.2 million in accelerated tenant improvement depreciation and $0.2 million in employee severance costs associated with the closure of our Hayward manufacturing facility which was announced during the three months ended September 30, 2008. These costs were offset in part by savings in labor, shipping, and materials costs reflecting efficiencies realized in our Charlotte facility, and other negotiated cost reductions.

	Three Months Ended September 30,			Nine Months Ended September 30,		
	2008	2007	% Change	2008	2007	% Change
	(in thousands)			(in thousands)		
Technology and development	$ 9,645	$ 7,579	27%	$ 28,642	$ 20,034	43%
Percentage of net revenues	27%	23%		27%	22%	
Sales and marketing	10,087	7,042	43%	26,762	19,421	38%
Percentage of net revenues	28%	22%		25%	22%	
General and administrative	6,772	7,352	(8)%	21,946	20,056	9%
Percentage of net revenues	19%	23%		21%	22%	

Our technology and development expense increased $2.1 million, or 27%, for the three months ended September 30, 2008 as compared to the same period in 2007. As a percentage of net revenues, this expense increased from 23% to 27% for the same comparable period. For the nine months ended September 30, 2008, technology and development expense increased $8.6 million, or 43%, as compared to the same period in 2007. As a percentage of revenue, technology and development expense for the nine months ended September 30, 2008 increased from 22% to 27% for the same comparable period. The overall increase in technology and development expense was attributable to increased personnel and related costs for employees and consultants involved with website development and website infrastructure support teams, which totaled $0.4 million and $2.5 million, respectively. For the three and nine month periods ended September 30, 2008, depreciation expenses increased $0.7 million and $3.2 million, and repair and maintenance expenses and co-location expenses increased $0.6 million and $1.7 million, respectively, related to our investments in website infrastructure hardware and bandwidth to support our continued revenue growth. In addition, for the nine months ended September 30, 2008, we incurred a loss on disposal of previously capitalized software development costs due to that technologies obsolescence totaling $0.3 million. Stock-based compensation expense was $0.6 million and $1.5 million in the three months and nine months ended September 30, 2008, compared to $0.2 million and $0.6 million in the three months and nine months ended September 30, 2007.

Our sales and marketing expense increased $3.0 million, or 43%, for the three months ended September 30, 2008 as compared to the same period in 2007. As a percentage of net revenues, this expense increased from 22% to 28% for the same comparable period. For the nine months ended September 30, 2008, sales and marketing expense increased

$7.3 million, or 38%, as compared to the same period in 2007. This expense increased as a percentage of net revenues from 22% to 25% for the same comparable period. Personnel and related costs for employees and consultants increased by $0.6 million and $2.1 million due to increased headcount. Our expenditures incurred on customer acquisition and promotion costs increased by $2.1 million and $4.1 million for the three months and nine months ended September 30, 2008. Increases are primarily associated with expanded online media and direct response marketing campaigns, along with an expansion of our internal marketing team. In addition, stock-based compensation expense was $0.6 million and $1.6 million in the three months and nine months ended September 30, 2008, compared to $0.3 million and $0.6 million in the same periods of 2007.

Our general and administrative expense decreased $0.6 million, or 8%, for the three months ended September 30, 2008 as compared to the same period in 2007. This expense decreased as a percentage of net revenues from 23% to 19%. For the nine months ended September 30, 2008, general and administrative expense increased $1.9 million, or 9%, as compared to the same period in 2007. This expense decreased as a percentage of net revenues from 22% to 21%. Personnel and related costs for employees remained flat and increased by $0.7 million for the three months and nine months ended September 30, 2008 as compared to the same periods in 2007 reflecting increased hiring in 2008 and an increase in stock-based compensation to $1.1 million and $3.0 million, in 2008, compared to $0.5 million and $1.5 million in 2007. Accounting and legal fees were flat and increased by $0.8 million for the three months and nine months ended September 30, 2008 as compared to the same periods in 2007. Payment processing fees paid to third parties were flat and increased by $0.2 million during the three months and nine months ended September 30, 2008 as compared to the same periods in 2007. Building rent and building management fees increased $0.3 million and $0.6 million, and depreciation increased $0.2 million and $0.6 million during the three months and nine months ended September 30, 2008 as compared to the same periods in 2007. Increases are attributable to our office lease expansion and ERP implementation which is offset by efficiencies from our Sarbanes-Oxley compliance efforts and reduced contractor utilization. Also offsetting general and administrative expenses for the three months ended September 30, 2008 was the first of two installment payments from a multi-million dollar cross-licensing agreement entered into with a digital imaging company. We expect to recognize the remaining installment under the agreement when the amount is received in the third quarter of 2009. Included in the general and administrative expenses for the nine months ended September 30, 2008 was the receipt of the first annual installment received in the first quarter of 2008 from a multi-million dollar intellectual property cross-licensing agreement with American Greetings, Inc. We expect to recognize the remaining two installments under the agreement when those amounts are received in the first quarter of both fiscal year 2009 and 2010.

	Three Months Ended September 30,			Nine Months Ended September 30,		
	2008	2007	Change	2008	2007	Change
	(in thousands)			(in thousands)		
Interest expense	$ (100)	$ (54)	$ (46)	$ (185)	$ (147)	$ (38)
Interest income	455	1,350	(895)	2,514	4,252	(1,738)

Interest expense increased by $46,000 or 85% and increased $38,000 or 26% for the three and nine months ended September 30, 2008, respectively, as compared to the same periods in 2007, due primarily to a decrease in interest expense on capitalized lease obligations. For the three and nine months ended September 30, 2008, $88,000 and $0.1 million has been amortized associated with the line of credit origination costs.

Interest income decreased by $0.9 million or 66% and $1.7 million or 41% for the three and nine months ended September 30, 2008 as compared to the same periods in 2007. This decrease for both the three and nine month periods was the result of an overall lower yield on our investment portfolio, including our auction rate securities, relative to our investment balances in the comparable prior year periods.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
	(in thousands)		(in thousands)	
Benefit from income taxes	$ 5,915	$ 2,001	$ 12,655	$ 4,515
Effective tax rate	69%	38%	55%	40%

The benefit from income taxes was $5.9 million and $12.7 million for the three and nine months ended September 30, 2008, compared to benefits of $2.0 million and $4.5 million for the same periods in 2007. The "Emergency Economic Stabilization Act of 2008," which contains the "Tax Extenders and Alternative Minimum Tax Relief Act of 2008," was signed into law on October 3, 2008. Under the Act, the research credit was retroactively extended for amounts paid or incurred after December 31, 2007 and before January 1, 2010. The effects of the change in the tax law will be recognized in our fourth quarter, which is the quarter the law was enacted. We are currently in the process of analyzing the impact of the new law. We also are subject to tax rate sensitivities due to the fixed nature of our remaining permanent tax differences.

As of September 30, 2008, we had approximately $34 million of federal and $31 million of California net operating loss carryforwards available to reduce future taxable income. These net operating loss carryforwards begin to expire in 2020 and 2014 for federal and California tax purposes, respectively.

	Three Months Ended September 30,			Nine Months Ended September 30,		
	2008	2007	% Change	2008	2007	% Change
	(in thousands)			(in thousands)		
Loss before income taxes	$ (8,626)	$ (5,315)	62%	$ (23,022)	$ (11,329)	103%
Net loss	(2,711)	(3,314)	(18)%	(10,367)	(6,814)	52%

Net loss decreased by $0.6 million, or 18% and increased $3.6 million, or 52%, for the three and nine months ended September 30, 2008 as compared to the same period in 2007.

Liquidity and Capital Resources

	Nine Months Ended September 30,	
	2008	2007
	(in thousands)	
Consolidated Statements of Cash Flows Data:		
Purchases of property and equipment	$ 16,760	$ 28,501
Capitalization of software and website development costs	3,239	2,417
Depreciation and amortization	18,833	12,434
Net cash flows (used in) provided by operating activities	(3,360)	7,604
Net cash flows used in investing activities	(79,339)	(36,575)
Net cash flows provided by financing activities	752	1,519

We anticipate that our current cash and cash equivalents balances, cash generated from operations, and our line of credit will be sufficient to meet our working capital requirements, capital lease obligations, expansion plans and technology development projects for at least the next 12 months. The adequacy of these resources to meeting our liquidity needs beyond that period will depend on our growth, operating results and the capital expenditures required to meet possible increased demand for our products. If we require additional capital resources to grow our business internally or to acquire complementary technologies and businesses at any time in the future, we may seek to sell additional debt or equity. The sale of additional equity could result in additional dilution to our stockholders. Financing arrangements may not be available to us, or may not be in amounts or on terms acceptable to us.

Historically we have financed our operations and capital expenditures through operations, private sales of preferred stock, our initial public offering, lease financing and the use of bank and related-party loans. As a result of our initial public offering in September 2006, we raised approximately $80.9 million of proceeds, net of underwriters' discount, which we received on October 4, 2006. At September 30, 2008, we had $40.6 million of cash and cash equivalents. Cash equivalents are comprised of money market funds.

At September 30, 2008, $47.4 million ($52.3 million par value) of our marketable securities portfolio was invested in AAA rated investments in auction-rate debt securities ("ARS"). ARS are long-term variable rate bonds tied to short-term interest rates. After the initial issuance of the securities, the interest rate on the securities is reset periodically, at intervals established at the time of issuance (primarily every twenty-eight days), based on market demand for a reset period. Auction rate securities are bought and sold in the marketplace through a competitive bidding process often referred to as a "Dutch auction." If there is insufficient interest in the securities at the time of an auction, the auction may not be completed and the rates may be reset to predetermined "penalty" or "maximum" rates. Following such a failed auction, we would not be able to access our funds that are invested in the corresponding auction-rate securities until a future auction of these investments is successful or new buyers express interest in purchasing these securities in between reset dates.

From the inception of our investments in these ARS in January 2008, through September 30, 2008, due to the recent uncertainties in the credit markets, all scheduled auctions for ARS have failed. Consequently, the investments are not currently liquid and we will not be able to access these funds until a future auction of these investments is successful, the securities are called by the issuer or a buyer is found outside of the auction process. At the time of our initial investment and through the date of this report, all of our auction-rate securities remain AAA rated. The assets underlying each security are student loans and 90% of the principal amounts are guaranteed by the Federal Family Education Loan Program (FFELP). We believe we have the ability and intent to hold these ARS investments until the lack of liquidity in those markets is resolved. As a result, we have classified the entire balance of ARS as non-current investments on our condensed consolidated balance sheet.

Typically, the fair value of ARS investments approximates par value due to the frequent resets through the auction process. While we continue to earn interest on our ARS investments at the contractual rate, these investments are not currently trading and therefore do not have a readily determinable market value. Accordingly, the estimated fair value of the ARS no longer approximates par value.

At September 30, 2008, we utilized a discounted cash flow approach to determine the Level 3 valuation for the ARS investments. This analysis indicated a fair value of $47.4 million. The assumptions used in preparing the discounted cash flow model include estimates for interest rates, timing and amount of cash flows, credit and liquidity premiums, and expected holding periods of the ARS. These assumptions are volatile and subject to change as the underlying sources of these assumptions and market conditions change. They represent our estimates given available data as of September 30, 2008. Based on this assessment of fair value, as of September 30, 2008 we determined there was a decline in fair value of its ARS investments of $4.8 million which was deemed temporary. If in the future, we conclude that the impairment is other-than-temporary, there would be a change to our income statement equal to the amount of the unrealized loss at the time that conclusion was made.

In October 2008, we received an offer (the “Offer”) from UBS AG (“UBS”). As a UBS client who holds Auction Rate Securities ("ARS"), if we accept the Offer we will receive ARS Rights, which will entitle us to sell ARS to UBS affiliates during the period from June 30, 2010 to July 2, 2012 for a price equal to par value. In exchange for the issuance of the ARS Rights, the UBS affiliates will have the discretionary right to sell our eligible ARS on our behalf, without prior notification, at any time before expiration of the related ARS Right, so long as we receive par value for the sold ARS. The Offer is non-transferable and expires on November 14, 2008. We are currently evaluating the Offer and its potential financial statement impact.

On an annual basis, for the last three years our cash flows generated from operating activities have been in excess of our capital expenditure requirements. Accordingly, we continue to believe that we have sufficient liquid capital to fund our operations and capital requirements. As of September 30, 2008, we have access to our cash and cash equivalents and our other liquid investments, totaling $40.6 million. In addition, in April 2008, to supplement our overall liquidity position, we entered into a 364-day revolving credit facility with a financial institution to provide up to $20.0 million in additional capital resources. As of September 30, 2008, no amounts had been drawn against that facility.

Our industry is competitive and has endured periods of intense price competition. Because we plan to finance our operations and capital expenses largely through our operations, and because our results of operations are sensitive to the level of competition we face, increased competition could adversely affect our liquidity and capital resources. Increased competition could do so both by reducing our revenues and net income, as a result of reduced sales, reduced prices and increased promotional activities, among other factors, as well as by requiring us to spend cash on advertising and marketing in an effort to maintain or increase market share in the face of such competition. In addition, we intend to increase many of our expenses, including some capital expenses and some sales and marketing expense, in advance of anticipated higher future revenues. However, such increased expenses, while intended to support anticipated increases in future revenues, must be funded from current capital resources or from borrowings or equity financings. As a result, our ability to grow our business relying largely on funds from our operations is sensitive to competitive pressures and other risks relating to our liquidity or capital resources.

We anticipate that total capital expenditures will approximate $26 million in 2008. These expenditures will be used to purchase technology and equipment to support the growth in our business and to increase our production capacity and help enable us to respond more quickly and efficiently to customer demand. This range of capital expenditures, while significant, is not outside the ordinary course of our business or materially different from how we have expanded our business in the past. We believe that such capital expenditures will have a positive effect on our results of operations if demand increases in line with increases in our production capacity. However, these capital expenditures will have a negative effect on our results of operations if demand does not increase as we expect, and will have a negative effect on our results of operations in the short term if demand does not increase simultaneously, as we expect, with the capital expenditures spent to support increased demand.

Operating Activities. For the nine months ended September 30, 2008, net cash used in operating activities was $3.4 million, primarily due to our net loss of $10.4 million and the net change in operating assets and liabilities of $8.7 million, adjusted for non-cash items including $18.8 million of depreciation and amortization expense, $9.7 million of benefit from income taxes and $6.3 million of stock-based compensation.

For the nine months ended September 30, 2007, net cash provided by operating activities was $7.6 million, primarily due to our management of our working capital, in particular a combined $5.1 million increase in accounts payable and accrued liabilities, after adjusting for large non-cash items in the quarter including $12.4 million of depreciation and amortization expense, $4.5 million benefit from income taxes and $2.8 million of stock-based compensation.

Investing Activities. For the nine months ended September 30, 2008, net cash used in investing activities was $79.3 million. We used $20.0 million for capital expenditures for computer and network hardware for our website infrastructure and information technology systems, capital expenditures for production equipment for our manufacturing and production operations at our California and North Carolina facilities, and capitalized website development costs. An additional $52.3 million was used to purchase auction rate securities, offset by $3.0 million in proceeds from the sale of the short term investments. We also paid $10.1 million in cash consideration to acquire Nexo.

For the nine months ended September 30, 2007, net cash used in investing activities was $36.6 million. $30.9 million was used primarily for capital expenditures for manufacturing equipment, computer and network hardware to support our website infrastructure and information technology computer hardware. Capital expenditures also include our internally developed software and website costs. In addition, $2.7 million of net cash was used in the acquisition of business and intangibles, and $3.0 million was used for the purchase of short term investments.

Financing Activities. Our financing activities for the nine months ended September 30, 2008 provided cash of $0.7 million, primarily from $1.1 million of proceeds from issuance of common stock less cash used of $0.4 million of principal payments on capital lease obligations.

Our financing activities for the nine months ended September 30, 2007 provided cash of $1.5 million, primarily from $3.4 million of proceeds from issuance of common stock less cash used of $1.9 million of principal payments on capital lease obligations.

Off-Balance Sheet Arrangements

We do not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. In addition, we do not have any undisclosed borrowings or debt, and we have not entered into any synthetic leases. We are, therefore, not materially exposed to any financing, liquidity, market or credit risk that could arise if we had engaged in such relationships. As part of our June 2007 acquisition of Make It About Me! (“MIAM”), we agreed to make additional earnout payments if certain milestones are achieved through December 2008. As of September 30, 2008, the total potential remaining earnout payment is $0.4 million.

Recent Accounting Pronouncements

Effective January 1, 2008, we adopted SFAS No. 157, “Fair Value Measurements” (“FAS 157”). In February 2008, the FASB issued a staff position which provides a one year deferral of the effective date of SFAS 157 for all nonfinancial assets and liabilities except for those that were recognized or disclosed in the financial statements at fair value at least annually. Therefore, we have adopted the provision of FAS 157 with respect to its financial assets and liabilities only. FAS 157 defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. Fair value is defined under FAS 157 as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measure date. Valuation techniques used to measure fair value under FAS 157 must maximize the use of observable inputs and minimize the use of unobservable inputs. The adoption of this statement did not have a material impact on our consolidated results of operations and financial condition.

Effective January 1, 2008, we adopted FAS No. 159, “The Fair Value Option for Financial Assets and Financial Liabilities” (“FAS 159”) which permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. We did not elect to adopt the fair value option under this Statement.

In December 2007, the FASB issued FAS No. 141R, “Business Combinations” (“FAS 141R”) which replaces FAS No. 141 and establishes principles and requirements for how the acquirer of a business recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any non-controlling interest in the acquiree. FAS 141R also provides guidance for recognizing and measuring the goodwill acquired in the business combination and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. This Statement applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. Early adoption of FAS 141R is prohibited. We do not expect the adoption of FAS 141R to have a material effect on our financial position and results of operations.

In December 2007, the FASB issued SFAS No. 160, “Non-controlling Interests in Consolidated Financial Statements” (“FAS 160”) which amends ARB 51 to establish accounting and reporting standards for the non-controlling interest in a subsidiary and for the deconsolidation of a subsidiary. It clarifies that a non-controlling interest in a subsidiary is an ownership interest in the consolidated entity that should be reported as equity in the consolidated financial statements. In addition to the amendments to ARB 51, this Statement amends FASB Statement No. 128, Earnings per Share; so that earnings-per-share data will continue to be calculated the same way those data were calculated before this Statement was issued. This Statement is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. We do not expect the adoption of FAS 160 to have a material effect on our financial position or results of operations.

In April 2008, the Financial Accounting Standards Board ("FASB") issued FASB Staff Position ("FSP") No. 142-3, "Determination of the Useful Life of Intangible Assets". FSP 142-3 amends the factors an entity should consider in developing renewal or extension assumptions used in determining the useful life or recognized intangible assets under FASB Statement No. 142, "Goodwill and Other Intangible Assets". This new guidance applies prospectively to intangible assets that are acquired individually or with a group of other assets in business combinations and asset acquisitions. FSP 142-3 is effective for financial statements issued for fiscal years and interim periods beginning after December 15, 2008. Early adoption is prohibited. We do not expect the adoption of FSP 142-3 to have a material effect on our financial position or results of operations.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Interest Rate and Credit Risk. We have exposure to interest rate risk that relates primarily to our investment portfolio. All of our current investments are classified as cash equivalents and are carried at market value. We do not currently use or plan to use derivative financial instruments in our investment portfolio. The risk associated with fluctuating interest rates is limited to our investment portfolio and we do not believe that a 10% change in interest rates will have a significant impact on our interest income, operating results or liquidity.

As of September 30, 2008, our cash and cash equivalents were maintained by financial institutions in the United States and our deposits may be in excess of insured limits. We believe that the financial institutions that hold our investments are financially sound and, accordingly, minimal credit risk exists with respect to these investments.

At September 30, 2008, we held auction rate security investments which were AAA rated and 90% of the underlying assets were backed by FFELP. Due to the recent uncertainties in the credit market, these securities have been rendered temporarily illiquid, and the fair value of those investments is currently estimated to be $4.8 million below par value. We have classified these ARS investments as long-term assets which reflect our ability and intent to hold these investments until the lack of liquidity in those markets is resolved.

Inflation. We do not believe that inflation has had a material effect on our current business, financial condition or results of operations. If our costs were to become subject to significant inflationary pressures, for example, if the cost of our materials or the cost of shipping our products to customers were to incur substantial increases as a result of the rapid rise in the cost of oil, we may not be able to fully offset such higher costs through price increases. Our inability or failure to do so could harm our business, financial condition and results of operations.

ITEM 4. CONTROLS AND PROCEDURES

Our management, with the participation of our chief executive officer and chief financial officer, evaluated the effectiveness of our disclosure controls and procedures as of September 30, 2008. The term “disclosure controls and procedures,” as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 (“Exchange Act”), means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC’s rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company’s management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on the evaluation of our disclosure controls and procedures as of September 30, 2008, our chief executive officer and chief financial officer concluded that, as of such date, the Company’s disclosure controls and procedures were effective.

No change in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) occurred during the quarter ended September 30, 2008 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting except as indicated below.

During the third quarter of 2008, we completed our implementation of our new enterprise resource planning system. This is part of our strategy to provide scale in our operations, thereby improving our internal controls.

PART II — OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

On or about June 18, 2007, Fotomedia Technologies, LLC filed a lawsuit in the United States District Court for the Eastern District of Texas, against us and several other defendants alleging patent infringement. The Fotomedia Complaint seeks unspecified damages, costs, interest and attorneys' fees, and an injunction against all parties. In lieu of answering the Fotomedia Complaint, we moved to dismiss it by joining in a motion filed by co-defendant Photobucket.com, Inc. While the motion was pending and not yet decided, on or about November 6, 2007, Fotomedia filed an Amended Complaint. The Amended Complaint likewise alleges infringement of the same three patents and seeks unspecified damages, costs, interest and attorneys' fees, and a permanent injunction. However, the amended complaint dropped the allegations of willful infringement against us in connection with one of the patents-at-issue. Defendants moved to dismiss the Amended Complaint as well. The motion was denied by the Court, and we subsequently filed an answer to the Amended Complaint on October 8, 2008, as well as counterclaims seeking declarations of non-infringement and invalidity of the patents-in-suit. The Court has set a schedule in this matter, which includes a trial date of November 2, 2009. At this time, we do not believe that the amount of potential loss, if any, is reasonably estimable.

On or about February 5, 2008, Parallel Networks, LLC filed a lawsuit in the United States District Court for the Eastern District of Texas, against us and several other defendants alleging patent infringement. The Parallel Networks Complaint seeks unspecified damages, costs, interest and attorneys' fees, and an injunction against all parties. We filed an answer to the complaint on April 29, 2008. Plaintiff has moved to consolidate this case with an earlier case filed against Netflix, Inc., et al., which we have opposed. A hearing on this motion is set for November 6, 2008. In addition, we have joined a motion to stay the litigation based on pending reexaminations of the patents-in-suit filed in the U.S. Patent & Trademark Office. A hearing on this motion is also set for November 6, 2008. The Court has set a schedule in this matter, which includes a trial date of March 2, 2010. At this time, we do not believe that the amount of potential loss, if any, is reasonably estimable.

From time to time, we may be involved in various legal proceedings arising in the ordinary course of business. At September 30, 2008, in the opinion of management, there are no other matters that are expected to have a material adverse effect on our financial position, results of operations or cash flows.

ITEM 1A. RISK FACTORS

Our net revenues, operating results and cash requirements are affected by the seasonal nature of our business.

Our business is highly seasonal, with a high proportion of our net revenues, net income and operating cash flows generated during the fourth quarter. For example, we generated approximately 52% of our net revenues for 2007 in the fourth quarter of 2007, and the net income that we generated during the fourth quarter of 2007 was necessary for us to achieve profitability on an annual basis for 2007. In addition, we incur significant additional expenses in the period leading up to the fourth quarter holiday season in anticipation of higher sales volume in that period, including expenses related to the hiring and training of temporary workers to meet our seasonal needs, additional inventory and equipment purchases and increased advertising. If we are unable to accurately forecast and respond to consumer demand for our products during the fourth quarter, our financial results, reputation and brand will suffer and the market price of our common stock would likely decline.

We also base our operating expense budgets on expected net revenue trends. A portion of our expenses, such as office, lab facility, and various equipment leases and various personnel costs, are largely fixed and are based on our expectations of our peak levels of operations. We may be unable to adjust spending quickly enough to offset any unexpected revenue shortfall. Accordingly, any shortfall in net revenues may cause significant variation in operating results in any quarter.

In addition, our operations and performance depend on general economic conditions. The U.S. economy recently experienced, and could continue to experience, an economic downturn due to the crisis in credit markets, slower economic activity, concerns about inflation, increased energy costs, decreased consumer confidence, and other adverse business conditions. Such fluctuations in the U.S. economy could cause, among others, deterioration and continued decline in consumer spending and increase in the cost of labor and materials. As a result, given the combination of the current economic conditions, very low consumer sentiment, limited discretionary funds and an abbreviated shopping period, we believe that this fourth quarter will be our most challenging on record and that our top-line results will be difficult to predict.

Our limited operating history makes it difficult to assess the exact impact of the seasonal factors on our business or the extent to which our business is susceptible to cyclical fluctuations in the U.S. economy. In addition, our historically rapid growth may have overshadowed whatever seasonal or cyclical factors might have influenced our business to date. Seasonal or cyclical variations in our business may become more pronounced over time and may harm our future operating results.

Economic trends could adversely affect our financial performance.

We are subject to macro-economic fluctuations in the U.S. economy. Recent macro-economic issues involving the broader financial markets, including the housing and credit system and the liquidity issues in the auction rate securities that we have invested in, have negatively impacted the economy and may negatively affect our growth. In addition, weak economic conditions and declines in consumer spending and consumption may harm operating results. Purchases of our products are often discretionary. If the economic climate deteriorates, customers or potential customers could delay, reduce or forego their purchases of our products and services, which could impact our business in a number of ways, including lower prices for our products and services and reduced sales.

If the negative macro-economic conditions persist, or if the economy enters a prolonged period of decelerating growth, our results of operations may be harmed.

If we are unable to meet our production requirements, our net revenues and results of operations would be harmed.

We believe that we must continue to grow our current production capability to meet our projected net revenue targets. We anticipate that total capital expenditures will approximate $26 million in 2008, a portion of which we expect will be used to add manufacturing capacity. During 2007, we opened a new manufacturing and production plant in Charlotte, North Carolina, and in July 2008 we announced that we will be closing our Hayward, California production facility in early 2009 and expect to begin operations in a new manufacturing and production facility in Phoenix, Arizona by April 1, 2009. Operational difficulties, such as a significant interruption in the operation or opening of any of our plants could delay production or shipment of our products. Our inability to meet our production requirements could lead to customer dissatisfaction and damage to our reputation and brand, which would result in reduced net revenues. Moreover, if the costs of meeting production requirements, including capital expenditures, were to exceed our expectations, our results of operations would be harmed.

In connection with the start-up of our new Phoenix manufacturing and production plant, there could be unforeseen construction, scheduling, engineering, cost or other problems with the build-out of the facility where the plant will be located that could cause the operation commencement date to differ significantly from initial expectations. Any significant delay in the commencement of operations at the new plant could cause a delay in our production requirements and harm our business, financial condition and results of operations. The new plant could also experience other operational disruptions, including telecommunications system problems, disruptions in transitioning fulfillment orders and problems or increased expenses associated with operating the new plant, which could harm our business, financial condition and results of operations.

In addition, we face significant production risks at peak holiday seasons, including the risks of obtaining sufficient qualified seasonal production personnel. A majority of our workforce during the fourth quarter of 2007 was seasonal, temporary personnel. We have had difficulties in the past finding a sufficient number of qualified seasonal employees, and our failure to obtain qualified seasonal production personnel at any of our production plants could harm our operations.

Our quarterly financial results may fluctuate, which may lead to volatility in our stock price.

Our future revenues and operating results may vary significantly from quarter-to-quarter due to a number of factors, many of which are difficult for us to predict and control. Factors that could cause our quarterly operating results to fluctuate include:

- general economic conditions, including higher inflation and the possibility of a recession and economic slowdown in the U.S. and worldwide, as well as those economic conditions specific to the Internet and ecommerce industries

- demand for our products and services, including seasonal demand;

- our pricing and marketing strategies and those of our competitors;

- our ability to attract visitors to our website and convert those visitors into customers;

- our ability to retain customers and encourage repeat purchases;

- our ability to sustain our profit margins, and our ability to diversify our product offerings and sell to consumers photo-based products such as photo books, calendars and cards;

- the costs of customer acquisition;

- our ability to manage our production and fulfillment operations;

- the costs to produce our prints and photo-based products and merchandise and to provide our services;

- the costs of expanding or enhancing our technology or website;

- a significant increase in returns and credits, beyond our estimated allowances, for customers who are not satisfied with our products;

- declines or disruptions to the travel industry;

- variations in weather, particularly heavy rain and snow which tend to depress travel and picture taking;

- the timing of holidays;

- volatility in our stock price, which may lead to higher stock-based compensation expense;

- consumer preferences for digital photography services;

- improvements to the quality, cost and convenience of desktop printing of digital pictures and products; and
- macroeconomic and geopolitical events such as recession, inflation, war, threat of war or terrorist actions.

Based on the factors cited above, we believe that quarter-to-quarter comparisons of our operating results are not a good indication of our future performance. It is possible that in one or more future quarters, our operating results may be below the expectations of public market analysts and investors. In that event, the trading price of our common stock may decline.

We have incurred operating losses in the past and may not be able to sustain profitability in the future.

We have periodically experienced operating losses since our inception in 1999. In particular, we make investments in our business that generally results in operating losses in each of the first three quarters of our fiscal year. This typically has enabled us to generate the majority of our net revenue during the fourth quarter and to achieve profitability for the full fiscal year. If we are unable to produce our products and provide our services at commercially reasonable costs, if revenues decline or if our expenses exceed our expectations, we may not be able to sustain or increase profitability on a quarterly or annual basis.

We have a limited public company operating history, which makes it difficult to evaluate our business and prospects for the future.

We became a public company in September 2006, and we have only a limited public operating history on which investors can base an evaluation of our business and future prospects. We face many risks, uncertainties, expenses and difficulties. To address these risks and uncertainties, we must do the following:

- maintain and increase the size of our customer base;
- maintain and enhance our brand;
- maintain and grow our website and customer operations;
- enhance and expand our products and services;
- successfully execute our business and marketing strategy;
- continue to develop and upgrade our technology and information processing systems;
- continue to enhance our service to meet the needs of a changing market;
- provide superior customer service;
- respond to competitive developments; and
- attract, integrate, retain and motivate qualified personnel.

We may be unable to accomplish one or more of these requirements, which could cause our business to suffer. Accomplishing one or more of these requirements might be very expensive, which could harm our financial results.

If we are not able to reliably meet our data storage and management requirements, customer satisfaction and our reputation could be harmed.

As a part of our current business model, we offer our customers free unlimited online storage and sharing of photographs and, as a result, must store and manage multiple petabytes of data. This policy results in immense system requirements and substantial ongoing technological challenges, both of which are expected to continue to increase over time. If we are not able to reliably meet these data storage and management requirements, we could have disruptions in services which could impair customer satisfaction and our reputation and lead to reduced net revenues and increased expenses. Moreover, if the cost of meeting these data storage and management requirements exceeds our expectations, our results of operations would be harmed.

Our data storage system could suffer damage or interruption from human error, fire, flood, power loss, telecommunications failure, break-ins, terrorist attacks, acts of war and similar events. In addition, our primary storage facilities are located near a major fault line, increasing our susceptibility to the risk that an earthquake could significantly harm our data storage system. If we experience disruption to our redundant systems located at our data storage center, such disruption could result in the deletion or corruption of customer stored images. For example, in 2007, we experienced a loss of a small number of customer images due to an isolated server failure.

Interruptions to our website, information technology systems, print production processes or customer service operations could damage our reputation and brand and substantially harm our business and results of operations.

The satisfactory performance, reliability and availability of our website, information technology systems, printing production processes and customer service operations are critical to our reputation, and our ability to attract and retain customers and maintain adequate customer satisfaction. We currently conduct periodic site maintenance several times a quarter that sometimes requires us to take the website down. The scheduled down times are planned at non-peak hours, typically at midnight. Any interruptions that result in the unavailability of our website or reduced order fulfillment performance or customer service could result in negative publicity, damage our reputation and brand and cause our business and results of operations to suffer. For example, in the second quarter of 2008, we experienced website performance issues in conjunction with a large release of additional website functionality which impacted our key metrics and revenue. This risk is heightened in the fourth quarter, as we experience significantly increased traffic to our website during the holiday season. Any interruption that occurs during such time would have a disproportionately negative impact than if it occurred during a different quarter.

We depend in part on third parties to implement and maintain certain aspects of our communications and printing systems. Therefore many of the causes of system interruptions or interruptions in the production process may be outside of our control. As a result, we may not be able to remedy such interruptions in a timely manner, or at all. Our business interruption insurance policies do not address all potential causes of business interruptions that we may experience, and any proceeds we may receive from these policies in the event of a business interruption may not fully compensate us for the revenues we may lose.

We may have difficulty managing our growth and expanding our operations successfully.

We have grown from 403 employees as of September 30, 2007 to 512 employees as of September 30, 2008. We have website operations, offices and customer support centers in Redwood City, California and Mesa, Arizona, and production facilities in Charlotte, North Carolina, Hayward, California (through early 2009), and a new facility in Phoenix, Arizona that is expected to be operational in early 2009. Our growth has placed, and will continue to place, a strain on our administrative and operational infrastructure. Our ability to manage our operations and growth will require us to continue to refine our operational, financial and management controls, human resource policies and reporting systems.

If we are unable to manage future expansion, we may not be able to implement improvements to our controls, policies and systems in an efficient or timely manner and may discover deficiencies in existing systems and controls. Our ability to provide a high-quality customer experience could be compromised, which would damage our reputation and brand and substantially harm our business and results of operations.

We recently implemented a new enterprise resource planning system ("ERP") as part of our strategy to provide scale in our operations. The ERP system is complex and could have flaws that could negatively impact our business and operations. Moreover, our internal processes may not be entirely compatible with the ERP system, which may require additional resources to ensure compatibility.

Competitive pricing pressures, particularly with respect to 4×6 print pricing and shipping, may harm our business and results of operations.

Demand for our products and services is sensitive to price. Many external factors, including our production and personnel costs and our competitors' pricing and marketing strategies, can significantly impact our pricing strategies. If we fail to meet our customers' price expectations, we could lose customers, which would harm our business and results of operations.

Changes in our pricing strategies have had, and may continue to have, a significant impact on our net revenues and net income. From time to time, we have made changes to our pricing structure for 4×6 prints in order to remain competitive. In December 2007, one of our competitors lowered their list prices on 4×6 prints from $0.12 to $0.09. During the third quarter of 2008, we lowered the list price of 4x6 prints from $0.19 to $0.15 based on the favorable results of a promotion in the second quarter of 2008. We expect to continue to test other pricing, promotion and bundled service offerings, however, a significant drop in our 4×6 prices, without a corresponding increase in volume, or decreases in volume as a result of competitive pressures would negatively impact our net revenues and could adversely affect our gross margins and overall profitability.

We generate a significant portion of our net revenues from the fees we collect from shipping our products. For example, these fees represented approximately 19%, 20% and 19% of our net revenues in 2007, 2006 and 2005 respectively. We offer discounted or free shipping, with a minimum purchase requirement, during promotional periods to attract and retain customers. If free shipping offers extend beyond a limited number of occasions, are not based upon a minimum purchase requirement or become commonplace, our net revenues and results of operations would be negatively impacted. In addition, we occasionally offer free or discounted products and services to attract and retain customers. In the future, if we increase these offers to respond to actions taken by our competitors, our results of operations may be harmed.

We face intense competition from a range of competitors and may be unsuccessful in competing against current and future competitors.

The digital photography products and services industries are intensely competitive, and we expect competition to increase in the future as current competitors improve their offerings and as new participants enter the market or as industry consolidation further develops. Competition may result in pricing pressures, reduced profit margins or loss of market share, any of which could substantially harm our business and results of operations. We face intense competition from a wide range of companies, including the following:

- Online digital photography services companies such as Kodak EasyShare Gallery (formerly known as Ofoto), Snapfish, which is a service of Hewlett-Packard, American Greetings' Photoworks and Webshots brands, and others;

- "Big Box" retailers such as Wal-Mart, Costco and others that are seeking to offer low cost digital photography products and services, such as in-store fulfillment and self-service kiosks for printing; these competitors may, among other strategies, offer their customers heavily discounted in-store products and services that compete directly with our offerings;

- Drug stores such as Walgreens, CVS and others that offer in-store pick-up from Internet orders;
- Regional photography companies such as Wolf Camera and Ritz Camera that have established brands and customer bases in existing photography markets;
- Internet portals and search engines such as Yahoo!, AOL, Google that offer broad-reaching digital photography and related products and services to their large user bases;
- Home printing service providers such as Hewlett-Packard, Epson, Canon, and Kodak that are seeking to expand their printer and ink businesses by gaining market share in the emerging digital photography marketplace; and
- Photo-related software companies such as Adobe, Apple, Microsoft, Corel and others.

Many of our competitors have significantly longer operating histories, larger and broader customer bases, greater brand and name recognition and greater financial, research and development and distribution resources, and operate in more geographic areas than we do. The numerous choices for digital photography services can cause confusion for consumers, and may cause them to select a competitor with greater name recognition. Some competitors are able to devote substantially more resources to website and systems development, or to investments or partnerships with traditional and online competitors. Competitors that are well-funded, particularly new entrants, may choose to prioritize growing their market share and brand awareness instead of profitability. Competitors and new entrants in the digital photography products and services industries may develop new products, technologies or capabilities that could render obsolete or less competitive many of the products, services and content that we offer. We may be unable to compete successfully against current and future competitors, and competitive pressures could harm our business and prospects.

If we are unable to adequately control the costs associated with operating our business, our results of operations will suffer.

The primary costs in operating our business are related to producing and shipping products, acquiring customers, compensating our personnel and acquiring equipment and technology and leasing facilities. If we are unable to keep these costs aligned with the level of revenues that we generate, our results of operations would be harmed. Controlling our business costs is challenging because many of the factors that impact these costs are beyond our control. For example, the costs to produce prints, such as the costs of photographic print paper, could increase due to a shortage of silver or an increase in worldwide energy prices. In addition, we may become subject to increased costs by the third-party shippers that deliver our products to our customers, and we may be unable to pass along any increases in shipping costs to our customers. The costs of online advertising and keyword search could also increase significantly due to increased competition, which would increase our customer acquisition costs.

We invest in securities that are subject to market risk and the recent issues in the financial markets could adversely affect the value of our assets.

At September 30, 2008, $47.4 million ($52.3 million par value) of our marketable securities portfolio was invested in AAA rated investments in auction-rate debt securities ("ARS"). ARS are long-term variable rate bonds tied to short-term interest rates. After the initial issuance of the securities, the interest rate on the securities is reset periodically, at intervals established at the time of issuance (primarily every twenty-eight days), based on market demand for a reset period. ARS are bought and sold in the marketplace through a competitive bidding process often referred to as a “Dutch auction.” If there is insufficient interest in the securities at the time of an auction, the auction may not be completed and the rates may be reset to predetermined “penalty” or “maximum” rates. Following such a failed auction, we would not be able to access our funds that are invested in the corresponding auction-rate securities until a future auction of these investments is successful or new buyers express interest in purchasing these securities in between reset dates.

From the inception of our investments in these ARS in January 2008, through September 30, 2008, due to the recent uncertainties in the credit markets, all scheduled auctions for ARS have failed. Consequently, the investments are not currently liquid and we will not be able to access these funds until a future auction of these investments is successful, the securities are called by the issuer or a buyer is found outside of the auction process. At the time of our initial investment and through the date of this report, all of our auction-rate securities remain AAA rated. The assets underlying each security are student loans and 90% of the principal amounts are guaranteed by the Federal Family Education Loan Program (FFELP). We believe we have the ability and intent to hold these ARS investments until the lack of liquidity in those markets is resolved. As a result, we have classified the entire balance of ARS as non-current investments on its condensed consolidated balance sheet.

Typically, the fair value of ARS investments approximates par value due to the frequent resets through the auction process. While we continue to earn interest on our ARS investments at the contractual rate, these investments are not currently trading and therefore do not have a readily determinable market value. Accordingly, the estimated fair value of the ARS no longer approximates par value.

At September 30, 2008, we utilized a discounted cash flow approach to determine the Level 3 valuation for the ARS investments. This analysis indicated a fair value of $47.4 million. The assumptions used in preparing the discounted cash flow model include estimates for interest rates, timing and amount of cash flows, credit and liquidity premiums, and expected holding periods of the ARS. These assumptions are volatile and subject to change as the underlying sources of these assumptions and market conditions change. They represent our estimates given available data as of September 30, 2008. Based on this assessment of fair value, as of September 30, 2008 we determined there was a decline in fair value of its ARS investments of $4.8 million which was deemed temporary. If in the future, we conclude that the impairment is other-than-temporary, there would be a charge to our income statement equal to the amount of the unrealized loss at the time that conclusion was made.

In October 2008, we received an offer (the “Offer”) from UBS AG (“UBS”). As a UBS client who holds Auction Rate Securities ("ARS"), if we accept the Offer we will receive ARS Rights, which will entitle us to sell ARS to UBS affiliates during the period from June 30, 2010 to July 2, 2012 for a price equal to par value. In exchange for the issuance of the ARS Rights, the UBS affiliates will have the discretionary right to sell our eligible ARS on our behalf, without prior notification, at any time before expiration of the related ARS Right, so long as we receive par value for the sold ARS. The Offer is non-transferable and expires on November 14, 2008. We are currently evaluating the Offer and its potential financial statement impact.

On an annual basis, for the last three years our cash flows generated from operating activities have been in excess of our capital expenditure requirements. Accordingly, we continue to believe that we have sufficient liquid capital to fund our operations and capital requirements. As of September 30, 2008, we have access to our cash and cash equivalents and our other liquid investments, totaling $40.6 million. In addition, in April 2008, to supplement our overall liquidity position, we entered into a 364-day revolving credit facility with a financial institution to provide up to $20.0 million in additional capital resources. As of September 30, 2008, no amounts have been drawn against this facility.

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

We are highly dependent upon the continued service and performance of our senior management team and key technical, marketing and production personnel. The loss of these key employees, each of whom is “at will” and may terminate his or her employment relationship with us at any time, may significantly delay or prevent the achievement of our business objectives.

We believe that our future success will also depend in part on our continued ability to identify, hire, train and motivate qualified personnel. We face intense competition for qualified individuals from numerous technology, marketing, financial services, manufacturing and e-commerce companies. In addition, competition for qualified personnel is particularly intense in the San Francisco Bay Area, where our headquarters are located. We may be unable to attract and retain suitably qualified individuals who are capable of meeting our growing operational and managerial requirements, or we may be required to pay increased compensation in order to do so. Our failure to attract and retain qualified personnel could impair our ability to implement our business plan.

Our annual option pool increase is limited to the lesser of a) 4.62% of stock options issued and outstanding on the December 31 immediately prior to the date of increase or b) a lesser number as determined by the Board. In order to attract key personnel, in 2007 and during the first three quarters of 2008, the Board authorized additional inducement stock option grants and restricted stock awards totaling 515,000 to supplement our option pool. In the future, attracting key personnel may require a level of option grants in excess of the amount available in our option pool. Accordingly the Board may authorize additional inducement grants which could further dilute existing shareholders.

If we are unable to attract customers in a cost-effective manner, or if we were to become subject to e-mail blacklisting, traffic to our website would be reduced and our business and results of operations would be harmed.

Our success depends on our ability to attract customers in a cost-effective manner. We rely on a variety of methods to bring visitors to our website and promote our products, including paying fees to third parties who drive new customers to our website, purchasing search results from online search engines, e-mail and direct mail. We pay providers of online services, search engines, directories and other website and e-commerce businesses to provide content, advertising banners and other links that direct customers to our website. We also use e-mail and direct mail to offer free products and services to attract customers, and we offer substantial pricing discounts to encourage repeat purchases. Our methods of attracting customers, including acquiring customer lists from third parties, can involve substantial costs, regardless of whether we acquire new customers. Even if we are successful in acquiring and retaining customers, the cost involved in these efforts impact our results of operations. Customer lists are typically recorded as intangible assets and may be subject to impairment charges if the fair value of that list exceeds its carrying value. These potential impairment charges could harm our results from operations. If we are unable to enhance or maintain the methods we use to reach consumers, if the costs of attracting customers using these methods significantly increase, or if we are unable to develop new cost-effective means to obtain customers, our ability to attract new customers would be harmed, traffic to our website would be reduced and our business and results of operations would be harmed.

In addition, various private entities attempt to regulate the use of e-mail for commercial solicitation. These entities often advocate standards of conduct or practice that significantly exceed current legal requirements and classify certain e-mail solicitations that comply with current legal requirements as unsolicited bulk e-mails, or “spam.” In addition, we have noted unauthorized “spammers” utilize our domain name to solicit spam. Some of these entities maintain blacklists of companies and individuals, and the websites, Internet service providers and Internet protocol addresses associated with those entities or individuals that do not adhere to what the blacklisting entity believes are appropriate standards of conduct or practices for commercial e-mail solicitations. If a company’s Internet protocol addresses are listed by a blacklisting entity, e-mails sent from those addresses may be blocked if they are sent to any Internet domain or Internet address that subscribes to the blacklisting entity’s service or purchases its blacklist. From time to time we are blacklisted, sometimes without our knowledge, which could impair our ability to market our products and services, communicate with our customers and otherwise operate our business.

We may not succeed in promoting, strengthening and continuing to establish the Shutterfly brand, which would prevent us from acquiring new customers and increasing revenues.

A component of our business strategy is the continued promotion and strengthening of the Shutterfly brand. Due to the competitive nature of the digital photography products and services markets, if we are unable to successfully promote the Shutterfly brand, we may fail to substantially increase our net revenues. Customer awareness of, and the perceived value of, our brand will depend largely on the success of our marketing efforts and our ability to provide a consistent, high-quality customer experience. To promote our brand, we have incurred, and will continue to incur, substantial expense related to advertising and other marketing efforts.

Our ability to provide a high-quality customer experience also depends, in large part, on external factors over which we may have little or no control, including the reliability and performance of our suppliers and third-party Internet and communication infrastructure providers. For example, some of our products, such as select photo-based merchandise, are produced and shipped to customers by our third-party vendors, and we rely on these vendors to properly inspect and ship these products. In addition, we rely on third-party shippers, including the U.S. Postal Service and United Parcel Service, to deliver our products to customers. Strikes or other service interruptions affecting these shippers could impair our ability to deliver merchandise on a timely basis. Our products are also subject to damage during delivery and handling by our third-party shippers. Our failure to provide customers with high-quality products in a timely manner for any reason could substantially harm our reputation and our efforts to develop Shutterfly as a trusted brand. The failure of our brand promotion activities could adversely affect our ability to attract new customers and maintain customer relationships, which would substantially harm our business and results of operations.

Purchasers of digital photography products and services may not choose to shop online, which would harm our net revenues and results of operations.

The online market for digital photography products and services is less developed than the online market for other consumer products. If this market does not gain widespread acceptance, our business may suffer. Our success will depend in part on our ability to attract customers who have historically used traditional retail photography services or who have produced photographs and other products using self-service alternatives, such as printing at home. Furthermore, we may have to incur significantly higher and more sustained advertising and promotional expenditures or reduce the prices of our products and services in order to attract additional online consumers to our website and convert them into purchasing customers. Specific factors that could prevent prospective customers from purchasing from us include:

- the inability to physically handle and examine product samples;
- delivery time associated with Internet orders;
- concerns about the security of online transactions and the privacy of personal information;
- delayed shipments or shipments of incorrect or damaged products; and
- inconvenience associated with returning or exchanging purchased items.

If purchasers of digital photography products and services do not choose to shop online, our net revenues and results of operations would be harmed.

If affordable broadband access does not become widely available to consumers, our revenue growth will likely suffer.

Because our business currently involves consumers uploading and downloading large data files, we are highly dependent upon the availability of affordable broadband access to consumers. Many areas of the country still do not have broadband access, and the cost of broadband access may be too expensive for many potential customers. To the extent that broadband access is not available or not adopted by consumers due to cost, our revenue growth would likely suffer.

If the single facility where substantially all of our computer and communications hardware is located fails or if our production facilities fail, our business and results of operations would be harmed.

Our ability to successfully receive and fulfill orders and to provide high-quality customer service depends in part on the efficient and uninterrupted operation of our computer and communications systems. Substantially all of the computer hardware necessary to operate our website is located at a single third-party hosting facility in Santa Clara, California, and our production facilities are located in Charlotte, North Carolina, Hayward, California (through early 2009), and a new facility in Phoenix, Arizona that is expected to be operational in early 2009. Our systems and operations could suffer damage or interruption from human error, fire, flood, power loss, insufficient power availability, telecommunications failure, break-ins, terrorist attacks, acts of war and similar events. In addition, Hayward is located on, and Santa Clara is located near, a major fault line, increasing our susceptibility to the risk that an earthquake could significantly harm the operations of these facilities. We maintain business interruption insurance, however, this insurance may be insufficient to compensate us for losses that may occur, particularly from interruption due to an earthquake which is not covered under our current policy. We do not presently have redundant systems in multiple locations, although we are considering additional data centers in our facilities in Charlotte and our new facility in Phoenix, Arizona. In addition, the impact of any of these disasters on our business may be exacerbated by the fact that we are still in the process of developing our formal disaster recovery plan and we do not have a final plan in place.

Capacity constraints and system failures could prevent access to our website, which could harm our reputation and negatively affect our net revenues.

Our business requires that we have adequate capacity in our computer systems to cope with the high volume of visits to our website. As our operations grow in size and scope, we will need to improve and upgrade our computer systems and network infrastructure to ensure reliable access to our website, in order to offer customers enhanced and new products, services, capacity, features and functionality. The expansion of our systems and infrastructure may require us to commit substantial financial, operational and technical resources before the volume of our business increases, with no assurance that our net revenues will increase.

Our ability to provide high-quality products and service depends on the efficient and uninterrupted operation of our computer and communications systems. If our systems cannot be expanded in a timely manner to cope with increased website traffic, we could experience disruptions in service, slower response times, lower customer satisfaction, and delays in the introduction of new products and services. Any of these problems could harm our reputation and cause our net revenues to decline.

Our technology, infrastructure and processes may contain undetected errors or design faults that could result in decreased production, limited capacity or reduced demand.

Our technology, infrastructure and processes may contain undetected errors or design faults. These errors or design faults may cause our website to fail and result in loss of, or delay in, market acceptance of our products and services. If we experience a delay in a website release that results in customer dissatisfaction during the period required to correct errors and design faults, we would lose revenue. In the future, we may encounter scalability limitations, in current or future technology releases, or delays in the commercial release of any future version of our technology, infrastructure and processes that could seriously harm our business.

We currently depend on third party suppliers for our photographic print paper, printing machines and other supplies, which expose us to risks if these suppliers fail to perform under our agreements with them.

We have historically relied on an exclusive supply relationship with Fuji Photo Film U.S.A. to supply all of our photographic paper for silver halide print production, such as 4×6 prints. We have an agreement with Fuji that expires in April 2010, but if Fuji fails to perform in accordance with the terms of our agreement and if we are unable to secure a paper supply from a different source in a timely manner, we would likely fail to meet customer expectations, which could result in negative publicity, damage our reputation and brand and harm our business and results of operations. We purchase other photo-based supplies from third parties on a purchase order basis, and, as a result, these parties could increase their prices, reallocate supply to others, including our competitors, or choose to terminate their relationship with us. In addition, we purchase or rent the machines used to produce certain of our photo-based products from Hewlett-Packard, which is one of our primary competitors in the area of online digital photography services. This competition may influence their willingness to provide us with additional products or services. If we were required to switch vendors of machines for photo-based products, we may incur delays and incremental costs, which could harm our operating results.

We currently outsource some of our production of photo-based products to third parties, which exposes us to risks if these parties fail to perform under our agreements with them.

We currently outsource the production of some our photo-based products to third parties. If these parties fail to perform in accordance with the terms of our agreements and if we are unable to secure another outsource partner in a timely manner, we would likely fail to meet customer expectations, which could result in negative publicity, damage our reputation and brand and harm our business and results of operations.

If we are unable to develop, market and sell new products and services that address additional market opportunities, our results of operations may suffer. In addition, we may need to expand beyond our current customer demographic to grow our business.

Although historically we have focused our business on consumer markets for silver halide prints, such as 4×6 prints, and photo-based products, such as photo books and calendars, we intend to address, and demand may shift to, new products and services. In addition, we believe we may need to address additional markets and expand our customer demographic in order to further grow our business. We may not successfully expand our existing services or create new products and services, address new market segments or develop a significantly broader customer base. Any failure to address additional market opportunities could result in loss of market share, which would harm our business, financial condition and results of operations.

We may undertake acquisitions to expand our business, which may pose risks to our business and dilute the ownership of our existing stockholders.

A key component of our business strategy includes strengthening our competitive position and refining the customer experience on our website through internal development. However, from time to time, we may selectively pursue acquisitions of businesses, like our June 2007 acquisition of Make it About Me! (“MIAM”), our January 2008 acquisition of Nexo and other technologies or services. Integrating any newly acquired businesses, technologies or services is likely to be expensive and time consuming. To finance any acquisition, it may be necessary for us to raise additional funds through public or private financings. Additional funds may not be available on terms that are favorable to us, and, in the case of equity financings, would result in dilution to our stockholders. Also, the value of our stock may be insufficient to attract acquisition candidates. If we do complete any acquisitions, we may be unable to operate the acquired businesses profitably or otherwise implement our strategy successfully. If we are unable to integrate or any newly acquired entities, technologies or services effectively, our business and results of operations will suffer. The time and expense associated with finding suitable and compatible businesses, technologies or services could also disrupt our ongoing business and divert our management’s attention. Future acquisitions by us could also result in large and immediate write-offs or assumptions of debt and contingent liabilities, any of which could substantially harm our business and results of operations.

Our net revenues and results of operations are affected by the level of vacation and other travel by our customers, and any declines or disruptions in the travel industry could harm our business.

Because vacation and other travel is one of the primary occasions in which our customers utilize their digital cameras, our net revenues and results of operations are affected by the level of vacation and other travel by our customers. Accordingly, downturns or weaknesses in the travel industry could harm our business. Travel expenditures are sensitive to business and personal discretionary spending levels and tend to decline during general economic downturns such as those currently being experienced in the U.S. and worldwide. Events or weakness in the travel industry that could negatively affect the travel industry include price escalation in the airline industry or other travel-related industries, airline or other travel related strikes, safety concerns, including terrorist activities, inclement weather and airline bankruptcies or liquidations. In addition, high gasoline prices may lead to reduced travel in the United States. Any decrease in vacation or travel could harm our net revenues and results of operations.

Failure to adequately protect our intellectual property could substantially harm our business and results of operations.

We rely on a combination of patent, trademark, trade secret and copyright law and contractual restrictions to protect our intellectual property. These protective measures afford only limited protection. Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy aspects of our website features and functionalities or to obtain and use information that we consider proprietary, such as the technology used to operate our website, our production operations and our trademarks.

As of September 30, 2008, we had 20 patents issued and more than 26 patent applications pending in the United States. We intend to pursue corresponding patent coverage in other countries to the extent we believe such coverage is appropriate and cost efficient. We cannot ensure that any of our pending applications will be granted. In addition, third parties have in the past and could in the future bring infringement, invalidity, co-inventorship or similar claims with respect to any of our currently issued patents or any patents that may be issued to us in the future. Any such claims, whether or not successful, could be extremely costly, could damage our reputation and brand and substantially harm our business and results of operations.

Our primary brand is “Shutterfly.” We hold registrations for the Shutterfly service mark in our major markets of the United States and Canada, as well as in the European Community, Mexico, Japan, Australia and New Zealand. An additional application for the Shutterfly mark is pending in Brazil. Our competitors may adopt names similar to ours, thereby impeding our ability to build brand identity and possibly leading to customer confusion. In addition, there could be potential trade name or trademark infringement claims brought by owners of marks that are similar to Shutterfly or one of our other marks. The Shutterfly brand is a critical component of our marketing programs. If we lose the ability to use the Shutterfly service mark in any particular market, we could be forced to either incur significant additional marketing expenses within that market, or elect not to sell products in that market. Any claims or customer confusion related to our marks could damage our reputation and brand and substantially harm our business and results of operations.

If we become involved in intellectual property litigation or other proceedings related to a determination of rights, we could incur substantial costs, expenses or liability, lose our exclusive rights or be required to stop certain of our business activities.

Third parties may sue us for infringing their intellectual property rights. In June 2007, we were sued by FotoMedia Technologies, LLC alleging patent infringement. In February 2008, we were also sued by Parallel Networks, also alleging patent infringement. Likewise, we may need to resort to litigation to enforce our intellectual property rights or to determine the scope and validity of third-party proprietary rights.

The cost to us of any litigation or other proceeding relating to intellectual property rights, whether or not initiated by us and even if resolved in our favor, could be substantial, and the litigation would divert our management’s efforts from growing our business. Some of our competitors may be able to sustain the costs of complex intellectual property litigation more effectively than we can because they have substantially greater resources. Uncertainties resulting from the initiation and continuation of any litigation could limit our ability to continue our operations.

Alternatively, we may be required to, or decide to, enter into a license with a third party. For example, in May 2005, we entered into a settlement and license agreement to resolve litigation brought by a third party with respect to our alleged infringement of its patents. Under the terms of the agreement, we agreed to pay the third party a total of $2.0 million, and we received a license to its patents. Any future license required under any other party's patents may not be made available on commercially acceptable terms, if at all. In addition, such licenses are likely to be non-exclusive and, therefore, our competitors may have access to the same technology licensed to us. If we fail to obtain a required license and are unable to design around a patent, we may be unable to effectively conduct certain of our business activities, which could limit our ability to generate revenues and harm our results of operations and possibly prevent us from generating revenues sufficient to sustain our operations.

The inability to acquire or maintain domain names for our website could substantially harm our business and results of operations.

We currently are the registrant of the Internet domain name for our website, Shutterfly.com, as well as various related domain names. Domain names generally are regulated by Internet regulatory bodies and are controlled also by trademark and other related laws. The regulations governing domain names could change in ways that block or interfere with our ability to use relevant domains. Also, we might not be able to prevent third parties from registering or retaining domain names that interfere with our consumer communications, or infringe or otherwise decrease the value of our trademarks and other proprietary rights. Regulatory bodies also may establish additional generic or country-code top-level domains or modify the requirements for holding domain names. As a result, we might not be able to acquire or maintain the domain names that utilize the name Shutterfly in all of the countries in which we currently or intend to conduct business. This could substantially harm our business and results of operations.

We may be subject to past or future liabilities for collection of sales and use taxes, and the payment of corporate level taxes.

Our policies concerning the collection of sales and use taxes and the payment of certain corporate level taxes have been based upon decisions of the U.S. Supreme Court that determine when a taxpayer is deemed to have nexus with a state sufficient to impose tax obligations under the Commerce Clause of the U.S. Constitution. Those Supreme Court decisions require that the taxpayer be physically present before a state can require the collection of sales and use taxes. States are currently attempting to expand the definition of what constitutes physical presence for sales and use taxes. At the same time, the standard governing the imposition of other taxes, for instance, corporate income taxes, is less established and a number of state courts have recently concluded that the Commerce Clause definition of nexus should be expanded to include either "physical" or "economic" presence (essentially marketing activities) which is a broader definition than is used for sales and use tax.

In reliance upon the U.S. Supreme Court's decisions, we have continued to collect sales and use taxes in California, Nevada, Pennsylvania, North Carolina, New York, New Jersey, and Arizona where we have employees and/or property. Starting in June 2007, we also began collecting sales and use taxes in other states where we have implemented joint sales efforts with Target Corporation.

While we believe the U.S. Supreme Court decisions support our policies concerning the collection and payment of taxes, tax authorities could disagree with our interpretations. If sustained, those authorities might seek to impose past as well as future liability for taxes and/or penalties. Such impositions could also impose significant administrative burdens and decrease our future sales. Moreover, the U.S. Congress has been considering various initiatives that could limit or supersede the U.S. Supreme Court's position regarding sales and use taxes.

Our effective tax rate may be subject to fluctuation from federal and state audits, and disqualifying dispositions of stock options.

Future tax audits by taxing agencies for the open tax years could lead to fluctuations in our effective tax rate because the taxing authority may disagree with certain assumptions we have made regarding appropriate credits and deductions in filing our tax returns.

Under current stock option tax regulations, we are entitled to a stock option compensation tax deduction when employees exercise and sell their incentive stock options within a two year period for a taxable gain. Our current effective tax rate estimate does not incorporate this deduction as the extent of the deduction, based on employee option disposition activity is not currently determinable. These disqualifying dispositions could lead to future fluctuations in our effective tax rate for any given quarter or year.

Government regulation of the Internet and e-commerce is evolving, and unfavorable changes or failure by us to comply with these regulations could substantially harm our business and results of operations.

We are subject to general business regulations and laws as well as regulations and laws specifically governing the Internet and e-commerce. Existing and future laws and regulations may impede the growth of the Internet or other online services. These regulations and laws may cover taxation, restrictions on imports and exports, customs, tariffs, user privacy, data protection, pricing, content, copyrights, distribution, electronic contracts and other communications, consumer protection, the provision of online payment services, broadband residential Internet access and the characteristics and quality of products and services. It is not clear how existing laws governing issues such as property use and ownership, sales and other taxes, libel and personal privacy apply to the Internet and e-commerce as the vast majority of these laws were adopted prior to the advent of the Internet and do not contemplate or address the unique issues raised by the Internet or e-commerce. Those laws that do reference the Internet are only beginning to be interpreted by the courts and their applicability and reach are therefore uncertain. For example, the Digital Millennium Copyright Act, or DMCA, is intended, in part, to limit the liability of eligible online service providers for including (or for listing or linking to third-party websites that include) materials that infringe copyrights or other rights of others. Portions of the Communications Decency Act, or CDA, are intended to provide statutory protections to online service providers who distribute third-party content. We rely on the protections provided by both the DMCA and CDA in conducting our business. Any changes in these laws or judicial interpretations narrowing their protections will subject us to greater risk of liability and may increase our costs of compliance with these regulations or limit our ability to operate certain lines of business. The Children's Online Protection Act and the Children's Online Privacy Protection Act are intended to restrict the distribution of certain materials deemed harmful to children and impose additional restrictions on the ability of online services to collect user information from minors. In addition, the Protection of Children From Sexual Predators Act of 1998 requires online service providers to report evidence of violations of federal child pornography laws under certain circumstances. The costs of compliance with these regulations may increase in the future as a result of changes in the regulations or the interpretation of them. Further, any failures on our part to comply with these regulations may subject us to significant liabilities. Those current and future laws and regulations or unfavorable resolution of these issues may substantially harm our business and results of operations.

Legislation regarding copyright protection or content interdiction could impose complex and costly constraints on our business model.

Because of our focus on automation and high volumes, our operations do not involve, for the vast majority of our sales, any human-based review of content. Although our website's terms of use specifically require customers to represent that they have the right and authority to reproduce the content they provide and that the content is in full compliance with all relevant laws and regulations, we do not have the ability to determine the accuracy of these representations on a case-by-case basis. There is a risk that a customer may supply an image or other content that is the property of another party used without permission, that infringes the copyright or trademark of another party, or that would be considered to be defamatory, pornographic, hateful, racist, scandalous, obscene or otherwise offensive, objectionable or illegal under the laws or court decisions of the jurisdiction where that customer lives. There is, therefore, a risk that customers may intentionally or inadvertently order and receive products from us that are in violation of the rights of another party or a law or regulation of a particular jurisdiction. If we should become legally obligated in the future to perform manual screening and review for all orders destined for a jurisdiction, we will encounter increased production costs or may cease accepting orders for shipment to that jurisdiction. That could substantially harm our business and results of operations.

Our practice of offering free products and services could be subject to judicial or regulatory challenge.

We regularly offer free products and free shipping as an inducement for customers to try our products. Although we believe that we conspicuously and clearly communicate all details and conditions of these offers — for example, that customers are required to pay shipping, handling and/or processing charges to take advantage of the free product offer — we may be subject to claims from individuals or governmental regulators that our free offers are misleading or do not comply with applicable legislation. These claims may be expensive to defend and could divert management's time and attention. If we become subject to such claims in the future, or are required or elect to curtail or eliminate our use of free offers, our results of operations may be harmed.

Any failure by us to protect the confidential information of our customers and networks against security breaches and the risks associated with credit card fraud could damage our reputation and brand and substantially harm our business and results of operations.

A significant prerequisite to online commerce and communications is the secure transmission of confidential information over public networks. Our failure to prevent security breaches could damage our reputation and brand and substantially harm our business and results of operations. For example, a majority of our sales are billed to our customers' credit card accounts directly, orders are shipped to a customer's address, and customers log on using their e-mail address. We rely on encryption and authentication technology licensed from third parties to effect the secure transmission of confidential information, including credit card numbers. Advances in computer capabilities, new discoveries in the field of cryptography or other developments may result in a compromise or breach of the technology used by us to protect customer transaction data. In addition, any party who is able to illicitly obtain a user's password could access the user's transaction data, personal information or stored images. Any compromise of our security could damage our reputation and brand and expose us to a risk of loss or litigation and possible liability, which would substantially harm our business and results of operations. In addition, anyone who is able to circumvent our security measures could misappropriate proprietary information or cause interruptions in our operations. We may need to devote significant resources to protect against security breaches or to address problems caused by breaches.

In addition, under current credit card practices, we are liable for fraudulent credit card transactions because we do not obtain a cardholder's signature. We do not currently carry insurance against this risk. To date, we have experienced minimal losses from credit card fraud, but we continue to face the risk of significant losses from this type of fraud. Our failure to adequately control fraudulent credit card transactions could damage our reputation and brand and substantially harm our business and results of operations.

Changes in regulations or user concerns regarding privacy and protection of user data could harm our business.

Federal, state and international laws and regulations may govern the collection, use, sharing and security of data that we receive from our customers. In addition, we have and post on our website our own privacy policies and practices concerning the collection, use and disclosure of customer data. Any failure, or perceived failure, by us to comply with our posted privacy policies or with any data-related consent orders, Federal Trade Commission requirements or other federal, state or international privacy-related laws and regulations could result in proceedings or actions against us by governmental entities or others, which could potentially harm our business. Further, failure or perceived failure to comply with our policies or applicable requirements related to the collection, use or security of personal information or other privacy-related matters could damage our reputation and result in a loss of customers.

International expansion will require management attention and resources and may be unsuccessful, which could harm our future business development and existing domestic operations.

To date, we have conducted limited international operations, but we intend to expand into international markets in order to grow our business. These expansion plans will require significant management attention and resources and may be unsuccessful. We have limited experience adapting our products to conform to local cultures, standards and policies. We may have to compete with local companies which understand the local market better than we do. In addition, to achieve satisfactory performance for consumers in international locations it may be necessary to locate physical facilities, such as production facilities, in the foreign market. We do not have experience establishing such facilities overseas. We may not be successful in expanding into any international markets or in generating revenues from foreign operations. In addition, different privacy, censorship and liability standards and regulations and different intellectual property laws in foreign countries may cause our business to be harmed.

The success of our business depends on continued consumer adoption of digital photography

Our growth is highly dependent upon the continued adoption by consumers of digital photography. The digital photography market is rapidly evolving, characterized by changing technologies, intense price competition, additional competitors, evolving industry standards, frequent new service announcements and changing consumer demands and behaviors. To the extent that consumer adoption of digital photography does not continue to grow as expected, our revenue growth would likely suffer. Moreover, we face significant risks that, if the market for digital photography evolves in ways that we are not able to address due to changing technologies or consumer behaviors, pricing pressures, or otherwise, our current products and services may become less attractive, which would likely result in the loss of customers, as well as lower net revenues and/or increased expenses.

Maintaining and improving our financial controls and the requirements of being a public company may strain our resources, divert management’s attention and affect our ability to attract and retain qualified board members.

As a public company, we are subject to the reporting requirements of the Securities Exchange Act of 1934, the Sarbanes-Oxley Act of 2002 and the rules and regulations of The NASDAQ Stock Market. The requirements of these rules and regulations will likely continue to increase our legal, accounting and financial compliance costs, make some activities more difficult, time-consuming or costly and may also place undue strain on our personnel, systems and resources.

The Sarbanes-Oxley Act requires, among other things, that we maintain effective disclosure controls and procedures and effective internal control over financial reporting. Significant resources and management oversight are required to design, document, test, implement and monitor internal control over relevant processes and to, remediate any deficiencies. As a result, management’s attention may be diverted from other business concerns, which could harm our business, financial condition and results of operations. These efforts also involve substantial accounting related costs. In addition, if we are unable to continue to meet these requirements, we may not be able to remain listed on The NASDAQ Global Market.

Under the Sarbanes-Oxley Act and the rules and regulations of The NASDAQ Stock Market, we are required to maintain a board of directors with a majority of independent directors. These rules and regulations may make it more difficult and more expensive for us to maintain directors’ and officers’ liability insurance, and we may be required to accept reduced coverage or incur substantially higher costs to maintain coverage. If we are unable to maintain adequate directors’ and officers’ insurance, our ability to recruit and retain qualified directors and officers, especially those directors who may be considered independent for purposes of NASDAQ rules, will be significantly curtailed.

Our stock price may be volatile or may decline regardless of our operating performance.

The market price of our common stock may fluctuate significantly in response to numerous factors, many of which are beyond our control, including:

- price and volume fluctuations in the overall stock market;
- changes in operating performance and stock market valuations of other technology companies generally, or those in our industry in particular;
- the financial projections we may provide to the public, any changes in these projections or our failure to meet these projections;
- changes in financial estimates by any securities analysts who follow our company, our failure to meet these estimates or failure of those analysts to initiate or maintain coverage of our stock;
- ratings downgrades by any securities analysts who follow our company;
- the public's response to our press releases or other public announcements, including our filings with the SEC;
- announcements by us or our competitors of significant technical innovations, acquisitions, strategic partnerships, joint ventures or capital commitments;
- introduction of technologies or product enhancements that reduce the need for our products;
- market conditions or trends in our industry or the macro-economy as a whole;
- impairment or loss in value of our investments in auction rate securities;
- the loss of key personnel;
- lawsuits threatened or filed against us;
- future sales of our common stock by our executive officers, directors and significant stockholders; and
- other events or factors, including those resulting from war, incidents of terrorism or responses to these events.

Some provisions in our restated certificate of incorporation and restated bylaws and Delaware law may deter third parties from acquiring us.

Our restated certificate of incorporation and restated bylaws contain provisions that may make the acquisition of our company more difficult without the approval of our board of directors, including the following:

- our board is classified into three classes of directors, each with staggered three-year terms;
- only our chairman, our chief executive officer, our president, or a majority of our board of directors is authorized to call a special meeting of stockholders;
- our stockholders may take action only at a meeting of stockholders and not by written consent;
- vacancies on our board of directors may be filled only by our board of directors and not by stockholders;

- our certificate of incorporation authorizes undesignated preferred stock, the terms of which may be established and shares of which may be issued without stockholder approval; and

- advance notice procedures apply for stockholders to nominate candidates for election as directors or to bring matters before an annual meeting of stockholders.

These anti-takeover defenses could discourage, delay or prevent a transaction involving a change in control of our company. These provisions could also discourage proxy contests and make it more difficult for stockholders to elect directors of their choosing and to cause us to take other corporate actions they desire.

In addition, we are subject to Section 203 of the Delaware General Corporation Law, which, subject to some exceptions, prohibits “business combinations” between a Delaware corporation and an “interested stockholder,” which is generally defined as a stockholder who becomes a beneficial owner of 15% or more of a Delaware corporation’s voting stock, for a three-year period following the date that the stockholder became an interested stockholder. Section 203 could have the effect of delaying, deferring or preventing a change in control that our stockholders might consider to be in their best interests.

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

Unregistered Sales of Equity Securities

Not applicable

Use of Proceeds

The S-1 relating to our initial public offering was declared effective by the SEC on September 28, 2006 (Registration Statement File No. 333-135426), and the offering commenced the same day. J.P. Morgan Securities Inc. acted as the sole book-running manager for the offering and Piper Jaffray & Co. and Jefferies & Company, Inc. acted as co-managers of the offering.

The securities registered were 5,800,000 shares of common stock, plus 870,000 additional shares to cover the underwriters’ over-allotment option. The underwriters’ over-allotment option expired on October 28, 2006, and was not exercised by the underwriters. The aggregate public offering price of the offering amount registered, including shares to cover the underwriters’ over-allotment option, was $100,050,000. We sold 5,800,000 shares of our common stock for an aggregate offering price of $87,000,000, and the offering has terminated.

Expenses incurred in connection with the issuance and distribution of the securities registered were as follows:

- Underwriting discounts and commissions — $6,090,000

- Other expenses — $2,442,000

- Total expenses — $8,533,000

None of such payments were direct or indirect payments to any of our directors or officers or their associates or to persons owning ten percent or more of our common stock or direct or indirect payments to others.

The net offering proceeds to us after deducting underwriters’ discounts and the total expenses described above was approximately $78.5 million.

Through September 30, 2008, we have used approximately half of these proceeds to purchase capital equipment, acquire businesses, and for general operating purposes. We expect to continue to use the remainder of the net proceeds for general corporate purposes, including working capital, operating expenses, and capital expenditures. In addition, we may also use a portion of the net proceeds for the acquisition of, or investment in, companies, technologies, products or assets that complement our business.

Our management retains broad discretion in the allocation and use of the net proceeds of our initial public offering, and investors must rely on the judgment of our management regarding the application of the net proceeds. Pending specific utilization of the net proceeds as described above, we have invested the net proceeds of the offering in short-term, interest-bearing obligations, investment grade instruments, certificates of deposit or direct or guaranteed obligations of the United States. The investment objective with respect to net proceeds is capital preservation and liquidity so that such funds are readily available to fund our operations.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

Not applicable

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

Not applicable

ITEM 5. OTHER INFORMATION

Not applicable

ITEM 6. EXHIBITS

Exhibit Number	Description
10.01	Transition Agreement between the Company and Stanford Au dated August 26, 2008.
10.02	Lease Agreement between Liberty Cotton Center LLC and the Company, dated August 22, 2008, as amended on October 29, 2008
31.01	Certification of Chief Executive Officer Pursuant to Securities Exchange Act Rule 13a-14(a).
31.02	Certification of Chief Financial Officer Pursuant to Securities Exchange Act Rule 13a-14(a).
32.01	Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350 and Securities Exchange Act Rule 13a-14(b).**
32.02	Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350 and Securities Exchange Act Rule 13a-14(b).**

** This certification is not deemed “filed” for purposes of Section 18 of the Securities Exchange Act, or otherwise subject to the liability of that section. Such certification will not be deemed to be incorporated by reference into any filing under the Securities Act of 1933 or the Securities Exchange Act of 1934, except to the extent that Shutterfly specifically incorporates it by reference.

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.

SHUTTERFLY, INC.
(Registrant)

Dated: October 31, 2008	By:	/s/ Jeffrey T. Housenbold Jeffrey T. Housenbold President & Chief Executive Officer (Principal Executive Officer and duly authorized signatory)
Dated: October 31, 2008	By:	/s/ Mark J. Rubash Mark J. Rubash Senior Vice President & Chief Financial Officer (Principal Accounting Officer and duly authorized signatory)

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* Incorporated herein by reference to the corresponding exhibit of the S-1.

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