SHUTTERFLY INC
Form 10-Q
October 30, 2009

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, 2009
	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	94-3330068
(State or Other Jurisdiction of Incorporation or Organization)	(IRS Employer Identification No.)
2800 Bridge Parkway Redwood City, California	94065
(Address of Principal Executive Offices)	(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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the Registrant was required to submit and post such files). Yes o 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 28, 2009
Common stock, $0.0001 par value per share	25,673,740 shares

EXPLANATORY NOTE REGARDING RESTATEMENT OF OUR CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

This quarterly report contains the restated condensed consolidated statements of operations for the three and nine months ended September 30, 2008 and condensed consolidated statements of cash flows for the nine months ended September 30, 2008. See Note 9 of Notes to Condensed Consolidated Financial Statements appearing in Part I Item 1 of this quarterly report.

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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, 2009	December 31, 2008
ASSETS		
Current assets:		
Cash and cash equivalents	$63,250	$88,164
Short-term investments	48,375	-
Accounts receivable, net	3,607	5,992
Inventories	3,316	3,610
Deferred tax asset, current portion	1,030	1,194
Prepaid expenses and other current assets	15,703	4,749
Total current assets	135,281	103,709
Long-term investments	-	52,250
Property and equipment, net	43,217	48,108
Goodwill and intangible assets, net	13,872	14,547
Deferred tax asset, net of current portion	11,759	12,266
Other assets	4,719	2,417
Total assets	$208,848	$233,297
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$6,265	$11,214
Accrued liabilities	11,451	24,802
Deferred revenue	8,916	9,461
Total current liabilities	26,632	45,477
Other liabilities	1,621	1,018
Total liabilities	28,253	46,495
Stockholders' equity		
Common stock, $0.0001 par value; 100,000 shares authorized; 25,651 and 25,138 shares issued and outstanding on September 30, 2009 and December 31, 2008, respectively	3	2
Additional paid-in-capital	215,926	203,902

Accumulated deficit	(35,334)	(17,102)
Total stockholders' equity	180,595	186,802
Total liabilities and stockholders' equity	$208,848	$233,297

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,		Nine Months Ended September 30,	
	2009	2008 (As restated)	2009	2008 (As restated)
Net revenues	$40,495	$35,953	$115,365	$105,738
Cost of net revenues (1)	21,420	18,451	61,161	53,777
Gross profit	19,075	17,502	54,204	51,961
Operating expenses (1):				
Technology and development	11,390	9,689	33,347	28,796
Sales and marketing	9,377	10,138	26,075	26,936
General and administrative	7,363	6,901	22,642	22,299
Total operating expenses	28,130	26,728	82,064	78,031
Loss from operations	(9,055)	(9,226)	(27,860)	(26,070)
Interest expense	(22)	(100)	(136)	(185)
Interest and other income, net	74	455	681	2,514
Loss before income taxes	(9,003)	(8,871)	(27,315)	(23,741)
Benefit from income taxes	2,657	6,071	9,083	13,032
Net loss	$(6,346)	$(2,800)	$(18,232)	$(10,709)
Net loss per share - basic and diluted	$(0.25)	$(0.11)	$(0.72)	$(0.43)
Weighted-average shares outstanding - basic and diluted	25,517	25,067	25,303	25,020

(1) Stock-based compensation is allocated as follows:

Cost of net revenues	$119	$109	$297	$301
Technology and development	1,077	654	2,292	1,693
Sales and marketing	955	696	2,428	1,733
General and administrative	2,005	1,216	4,778	3,327

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,	
	2009	2008 (As restated)
Cash flows from operating activities:		
Net loss	$ (18,232)	$ (10,709)
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	18,844	17,463
Amortization of intangible assets	1,491	1,370
Stock-based compensation	9,795	7,054
Loss on disposal of property and equipment	79	308
Deferred income taxes	703	(10,123)
Changes in operating assets and liabilities:		
Accounts receivable, net	2,389	1,336
Inventories	294	1,518
Prepaid expenses and other current assets	(10,700)	(3,553)
Other assets	(2,421)	352
Accounts payable	(5,083)	(2,757)
Accrued and other liabilities	(14,737)	(6,087)
Deferred revenue	(546)	468
Net cash used in operating activities	(18,124)	(3,360)
Cash flows from investing activities:		
Acquisition of business and intangibles, net of cash acquired	(796)	(10,098)
Purchases of property and equipment	(8,272)	(16,760)
Capitalization of software and website development costs	(3,032)	(3,239)
Proceeds from sale of short term investments	-	3,002
Proceeds from sale of equipment	-	6
Purchase of auction rate securities	-	(52,250)
Proceeds from the sale of auction rate securities	3,875	-
Net cash used in investing activities	(8,225)	(79,339)
Cash flows from financing activities:		
Principal payments of capital lease obligations	(90)	(378)
Proceeds from issuance of common stock upon exercise of stock options	2,139	1,130
Shares withheld for payment of employee's withholding tax liability	(1,041)	-
Tax benefit of stock options recorded in additional paid-in capital	427	-
Net cash provided by financing activities	1,435	752
Net increase in cash and cash equivalents	(24,914)	(81,947)
Cash and cash equivalents, beginning of period	88,164	122,582

Cash and cash equivalents, end of period	$ 63,250	$40,635
Supplemental schedule of non-cash investing activities		
Net change in accrued purchases of property and equipment	$1,524	-
Escrow liability from acquisition of business	150	-

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 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 and videos; share pictures; order prints and create an assortment of personalized items such as stationery 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 subsidiary. In the opinion of management, all adjustments, consisting primarily of normal recurring accruals, 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 three and nine months ended September 30, 2009, are not necessarily indicative of the results that may be expected for the year ending December 31, 2009, or for any other period.

The December 31, 2008, 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, 2008, included in the Company’s Annual Report on Form 10-K/A.

Subsequent Events Evaluation

Management has reviewed and evaluated material subsequent events from the balance sheet date of September 30, 2009, through the financial statements issue date of October 30, 2009. All appropriate subsequent event disclosures have been made in the notes to our unaudited condensed consolidated financial statements.

Principles of Consolidation

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

Fair Value

The Company records its financial assets and liabilities at fair value. The accounting standard for fair value provides a framework for measuring fair value, clarifies the definition of fair value and expands disclosures regarding fair value measurements. Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability (an exit price) in an orderly transaction between market participants at the reporting date. The accounting standard establishes a three-tier hierarchy, which prioritizes the inputs used in the valuation methodologies in measuring fair value:

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.

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 the respective authoritative guidance. 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. As such, 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. No interest or penalties were accrued as of December 31, 2008 or September 30, 2009.

At September 30, 2009, the Company had $12.1 million and $10.3 million of federal and state net operating losses, respectively, associated with windfall tax benefits that will be recorded as additional paid-in capital when realized. A tax windfall is created when the tax deduction associated with stock options exercised and vesting of restricted stock units exceeds the recognized stock-based compensation expense. The Company is subject to taxation in California and other jurisdictions in the United States.

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 comprehensive loss.

The components of comprehensive loss were as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008
		(As restated)		(As restated)
Unrealized loss in investments, net of tax	$ --	$ (904)	$ --	$ (3,127)
Net loss	(6,346)	(2,800)	(18,232)	(10,709)
Total comprehensive loss	$ (6,346)	$ (3,704)	$ (18,232)	$ (13,836)

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

Recent Accounting Pronouncements

In February 2008, the FASB issued an accounting standard update that delayed the effective date of fair value measurements accounting for all non-financial assets and non-financial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually), until the beginning of the first quarter of fiscal 2009. These include goodwill and other non-amortizable intangible assets. The Company adopted this accounting standard update effective January 1, 2009. The adoption of this update to non-financial assets and liabilities, as codified in ASC 820-10 (formerly FSP 157-2, "Effective Date of FASB Statement No. 157"), did not have any impact on the Company's condensed consolidated financial statements.

Effective January 1, 2009, the Company adopted a new accounting standard update regarding business combinations. As codified under ASC 805 (formerly SFAS No. 141 revised 2007, "Business Combinations"), this update requires an entity to recognize the assets acquired, liabilities assumed, contractual contingencies, and contingent consideration at their fair value on the acquisition date. It further requires that acquisition-related costs be recognized separately from the acquisition and expensed as incurred; that restructuring costs generally be expensed in periods subsequent to the acquisition date; and that changes in accounting for deferred tax asset valuation allowances and acquired income tax uncertainties after the measurement period be recognized as a component of provision for taxes. In addition, acquired in-process research and development is capitalized as an intangible asset and amortized over its estimated useful life. With the adoption of this accounting standard update, any tax related adjustments associated with acquisitions that closed prior to January 1, 2009 will be recorded through income tax expense, whereas the previous accounting treatment would require any adjustment to be recognized through the purchase price. This accounting standard update 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. The adoption of these accounting updates did not have any impact on the Company's condensed consolidated financial statements.

Effective January 1, 2009, the Company adopted an accounting standard which establishes accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary, as codified in ASC 810-10 (formerly SFAS No. 160, Accounting and Reporting on Non-controlling Interest in Consolidated Financial Statements, an Amendment of ARB 51"). This accounting standard states that accounting and reporting for minority interests are to be recharacterized as noncontrolling interests and classified as a component of equity. The calculation of earnings per share continues to be based on income amounts attributable to the parent. The adoption of these accounting updates did not have any impact on the Company's condensed consolidated financial statements.

Effective January 1, 2009, the Company adopted an accounting standard update regarding the determination of the useful life of intangible assets. As codified in ASC 350-30-35 (formerly FSP No. 142-3, "Determination of the Useful Life of Intangible Assets"), this update amends the factors considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under intangibles accounting. It also requires a consistent approach between the useful life of a recognized intangible asset under prior business combination accounting and the period of expected cash flows used to measure the fair value of an asset under the new business combinations accounting (as currently codified under ASC 850). The update also requires enhanced disclosures when an intangible asset's expected future cash flows are affected by an entity's intent and/or ability to renew or extend the arrangement. The adoption of these accounting updates did not have any impact on the Company's condensed consolidated financial statements.

Effective January 1, 2009, the Company adopted a new accounting standard update from the Emerging Issues Task Force ("EITF") consensus regarding the accounting of defensive intangible assets. This update, as codified in ASC 350-30 (formerly EITF No. 08-7, "Accounting for Defensive Intangible Assets"), clarifies accounting for defensive intangible assets subsequent to initial measurement. It applies to acquired intangible assets which an entity has no intention of actively using, or intends to discontinue use of, the intangible asset but holds it to prevent others from obtaining access to it (i.e., a defensive intangible asset). Under this update, a consensus was reached that an acquired defensive asset should be accounted for as a separate unit of accounting (i.e., an asset separate from other assets of the acquirer); and the useful life assigned to an acquired defensive asset should be based on the period during which the asset would diminish in value. The adoption of these accounting updates did not have any impact on the Company's condensed consolidated financial statements.

Effective April 1, 2009, the Company adopted a new accounting standard for subsequent events, as codified in ASC 855-10 (formerly SFAS No. 165, Subsequent Events). The update modifies the names of the two types of subsequent events either as recognized subsequent events (previously referred to in practice as Type I subsequent events) or non-recognized subsequent events (previously referred to in practice as Type II subsequent events). In addition, the standard modifies the definition of subsequent events to refer to events or transactions that occur after the balance sheet date, but before the financial statements are issued (for public entities) or available to be issued (for nonpublic entities). It also requires the disclosure of the date through which subsequent events have been evaluated. The update did not result in significant changes in the practice of subsequent event disclosures, and therefore the adoption did not have any impact on the Company's consolidated financial statements.

Effective April 1, 2009, the Company adopted three accounting standard updates which were intended to provide additional application guidance and enhanced disclosures regarding fair value measurements and impairments of securities. They also provide additional guidelines for estimating fair value in accordance with fair value accounting. The first update, as codified in ASC 820-10-65 (formerly FASB Staff Positions ("FSP") No. 157-4, Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly), provides additional guidelines for estimating fair value in accordance with fair value accounting. The second accounting update, as codified in ASC 320-10-65 (formerly FSP No. 115-2, Recognition and Presentation of Other-Than-Temporary Impairments), changes accounting requirements for other-than-temporary-impairment (OTTI) for debt securities by replacing the current requirement that a holder have the positive intent and ability to hold an impaired security to recovery in order to conclude an impairment was temporary with a requirement that an entity conclude it does not intend to sell an impaired security and it will not be required to sell the security before the recovery of its amortized cost basis. The third accounting update, as codified in ASC 825-10-65 (formerly Accounting Principles Board ("APB") Opinion No. 28-1, Interim Disclosures about Fair Value of Financial Instruments), increases the frequency of fair value disclosures. These updates were effective for fiscal years and interim periods ended after June 15, 2009. The adoption of these accounting updates did not have any impact on the Company's condensed consolidated financial statements.

Effective July 1, 2009, the Company adopted The "FASB Accounting Standards Codification" and the Hierarchy of Generally Accepted Accounting Principles (ASC 105), (formerly SFAS No. 168, The "FASB Accounting Standards Codification" and the Hierarchy of Generally Accepted Accounting Principles). This standard establishes only two levels of U.S. generally accepted accounting principles ("GAAP"), authoritative and nonauthoritative. The Financial Accounting Standard Board ("FASB") Accounting Standards Codification (the "Codification") became the source of authoritative, nongovernmental GAAP, except for rules and interpretive releases of the SEC, which are sources of authoritative GAAP for SEC registrants. All other non-grandfathered, non-SEC accounting literature not included in the Codification became nonauthoritative. The Company began using the new guidelines and numbering system prescribed by the Codification when referring to GAAP in the third quarter of fiscal 2009. As the Codification was not intended to change or alter existing GAAP, it did not have any impact on the Company's condensed consolidated financial statements.

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Note 2 — Stock-Based Compensation

Stock Option Activity

A summary of the Company's stock option activity for the three and nine months ended September 30, 2009 is as follows (in thousands):

	Number of Options Outstanding	Weighted Average Exercise Price	Weighted Average Contractual Term (Years)	Aggregate Intrinsic Value
Balances, December 31, 2008	5,529	$ 13.41		
Granted	14	7.83		
Exercised	(14)	4.18		
Forfeited, cancelled or expired	(272)	13.44		
Balances, March 31, 2009	5,257	$ 13.42	7.2	$ 6,928
Granted	39	11.57		
Exercised	(128)	6.33		
Forfeited, cancelled or expired	(213)	17.60		
Balances, June 30, 2009	4,955	$ 13.43	7.0	$ 17,197
Granted	42	14.28		
Exercised	(187)	6.68		
Forfeited, cancelled or expired	(31)	16.96		
Balances, September 30, 2009	4,779	$ 13.67	6.8	$ 23,558
Options vested and expected to vest at September 30, 2009	4,461	$ 13.32	6.7	$ 22,949
Options vested at September 30, 2009	3,487	$ 11.92	6.3	$ 21,042

During the three months ended September 30, 2009, the Company granted options to purchase an aggregate of 42,000 shares of common stock with an estimated weighted-average grant-date fair value of $6.47 per share. The total intrinsic value of options exercised during the three months ended September 30, 2009, was $1,696,000. Net cash proceeds from the exercise of stock options were $1,270,000 for the three months ended September 30, 2009.

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 gives 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, 2009 and September 30, 2008, were as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008
Dividend yield	—	—	—	—
Annual risk free rate of return	2.5 %	2.9 %	2.3 %	2.6 %
Expected volatility	51.9 %	48.8 %	56.2 %	50.4 %
Expected term (years)	4.6	4.7	4.6	4.4

Employee stock-based compensation expense recognized in the three and nine months ended September 30, 2009, was calculated based on awards ultimately expected to vest and has been reduced for estimated forfeitures. Accounting standards require 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

The Company grants restricted stock units ("RSUs") to its employees under the provisions of the 2006 Equity Incentive Plan. The cost of RSUs is determined using the fair value of our common stock on the date of grant. RSUs typically vest and become exercisable annually, based on a two, three or four year total vesting term. 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 three and nine months ended September 30, 2009, is as follows (in thousands):

	Number of Units Outstanding	Weighted Average Grant Date Fair Value
Balances, December 31, 2008	958	$ 12.11
Granted	865	7.95
Vested	(18)	20.15
Forfeited, cancelled or expired	(103)	14.28
Balances, March 31, 2009	1,702	$ 9.78
Granted	350	12.99
Vested	(193)	15.21
Forfeited, cancelled or expired	(24)	12.73
Balances, June 30, 2009	1,835	$ 9.78
Granted	111	13.65
Vested	(49)	15.02

Forfeited, cancelled or expired	(17)		9.75
Balances, September 30, 2009	1,880	$	9.89

Included in the RSU grants for the three months ended September 30, 2009, are 66,000 RSUs that have both performance and service vesting criteria ("PBRSU"). The performance criteria is tied to the Company's financial performance for the three months ended September 30, 2009 and the vesting period is three years. Compensation cost associated with these PBRSUs is recognized based on whether or not satisfaction of the performance criteria is probable. As of September 30, 2009, the performance criteria for the fiscal quarter were met and the associated stock based compensation was recognized.

In connection with the acquisition of TinyPictures, Inc. on September 10, 2009, the Company granted PBRSUs to existing TinyPictures employees. Vesting of these awards are contingent on achieving certain performance milestones and continued employment. The Company will begin recognizing stock based compensation in the period in which achievement of each milestone is deemed probable. As of September 30, 2009, no stock-based compensation has been recognized associated with these PBRSUs.

Inducement Awards

In the nine months period ended September 30, 2009, the Company granted inducement awards of 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 200,000 restricted stock units were granted under this nonqualified agreement. These grants vest over a three year period beginning on the grant date.

At September 30, 2009, the Company had $23,130,000 of total unrecognized compensation expense, net of estimated forfeitures, related to stock options and stock awards that will be recognized over a weighted-average period of approximately two 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, reduced by the weighted average unvested common shares subject to repurchase by the Company.

Diluted net loss per share attributed to common shares 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 and settlement of RSUs.

A summary of the net loss per share for the three and nine months ended September 30, 2009 and 2008, is as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008 (as restated)	2009	2008 (as restated)
Historical net loss per share:				
Numerator				
Net loss	$ (6,346)	$ (2,800)	$ (18,232)	$ (10,709)
Denominator				
Weighted-average common shares outstanding	25,517	25,067	25,303	25,022

Less: Weighted-average unvested common shares subject to repurchase	—	—	—	(2)
Denominator for basic and diluted net loss per share	25,517	25,067	25,303	25,020
Net loss per share — basic and diluted	$ (0.25)	$ (0.11)	$ (0.72)	$ (0.43)

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 (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008
Options to purchase common stock, common stock subject to repurchase and restricted stock units	6,698	6,443	6,790	6,108

Note 4 — Fair Value Measurement

The following table represents the Company's fair value hierarchy for its financial assets (cash equivalents and investments) as of September 30, 2009 (in thousands):

	September 30, 2009			
	Fair Value	Level 1	Level 2	Level 3
Cash equivalents:				
Money market funds	$ 60,491	$ 60,491	$ —	$ —
Short-term investments:				
Auction rate securities	42,030	—	—	42,030
Rights on ARS securities	6,345	—	—	6,345
Total financial assets	$ 108,866	$ 60,491	$ —	$ 48,375

Level 3 assets consist of auction rate securities ("ARS") with an auction reset feature whose underlying assets are student loans that are substantially backed by the federal government. Because the auctions for these securities have continued to fail since February 2008, 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. The Company's ARS investments are held by UBS AG ("UBS"), one of the Company's investment providers. In November 2008, the Company accepted an offer (the "Right") from UBS entitling the Company to sell at par value ARS purchased from UBS (approximately $48.4 million, par value) at anytime during a two-year period from June 30, 2010 through July 2, 2012. Although the Company expects to sell its ARS under the Right, if the Right is not exercised before July 2, 2012, it will expire and UBS will have no further rights or obligation to buy the Company's ARS. UBS's obligations under the Right are not secured by its assets and do not require UBS to obtain any financing to support its performance obligations under the Right. UBS has disclaimed any assurance that it will have sufficient financial resources to satisfy its obligations under the Right. The Company has valued the ARS and Right using a discounted cash flow model based on Level 3 assumptions. The assumptions used in valuing the ARS and the Right include estimates of, based on data available as of September 30, 2009, interest rates, timing and amount of cash flows, credit and liquidity premiums, expected holding periods of the ARS, loan rates per the UBS Right and bearer risk associated with UBS's financial ability to repurchase the ARS beginning June 30, 2010.

During the nine months ended September 30, 2009 the Company liquidated $3.9 million (at par value) ARS investments that were called by the issuers. The Company intends to exercise the UBS Right on June 30, 2010, and as a result, has classified these ARS investments and the Right as short-term investments as of September 30, 2009.

The following table provides a summary of changes in fair value of the Company's ARS investments and the Right which are both Level 3 assets as of September 30, 2009 (in thousands):

	Rights	ARS
Balance at December 31, 2008	$ 9,013	$ 43,237
Sale of auction rate securities	-	(3,875)
Unrealized gain/(loss) included in earnings	(2,668)	2,668
Balance at September 30, 2009	$ 6,345	$ 42,030

Note 5 — Balance Sheet Components

Prepaid Expenses and Other Current Assets

	September 30, 2009	December 31, 2008
	(in thousands)	
Intra-period deferred tax asset	$ 10,213	$ -
Prepaid service contracts - current portion	2,718	2,818
Other prepaid expenses and current assets	2,772	1,931
	$ 15,703	$ 4,749

Property and Equipment

	September 30, 2009	December 31, 2008
	(in thousands)	
Computer and other equipment	$ 81,715	$ 78,299
Software	7,158	7,450
Leasehold improvements	6,848	8,933
Furniture and fixtures	2,862	2,609
Capitalized software and website development costs	16,290	12,622
	114,873	109,913
Less: Accumulated depreciation and amortization	(71,656)	(61,805)
Net property and equipment	$ 43,217	$ 48,108

Property and equipment includes $1,212,000 and $3,356,000 of equipment under capital leases at September 30, 2009 and December 31, 2008, respectively. Accumulated depreciation of assets under capital leases totaled $1,197,000 and $3,010,000 at September 30, 2009 and December 31, 2008, respectively.

Depreciation and amortization expense totaled $6,301,000 and $6,226,000 for the three months ended September 30, 2009 and 2008, respectively. Depreciation and amortization expense totaled $18,844,000 and $17,463,000 for the nine months ended September 30, 2009 and 2008, respectively.

During the nine months ended September 30, 2009, the Company retired $8,910,000 of fully depreciated property and equipment, primarily building leasehold improvements and equipment associated with the closure of the Company's Hayward production facility.

Accrued Liabilities

	September 30, 2009	December 31, 2008
	(in thousands)	
Accrued compensation	$ 2,743	$ 4,110
Accrued marketing expenses	2,456	6,697
Accrued purchases	2,119	952
Accrued sales taxes	1,051	5,923
Accrued production facility expenses	972	2,677
Accrued consultant expenses	738	1,439
Accrued other	1,372	3,004
	$ 11,451	$ 24,802

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. At the time of the decision, the Company recorded approximately $80,000 in contractual lease termination costs. The Company completed its closure of the Hayward facility in the first quarter of fiscal 2009. The Company paid a total of $827,000 in severance costs, which was recognized ratably over the period from the severance communication date in July 2008 through March 31, 2009. The Company recorded an additional restructuring accrual as of March 31, 2009, for rent and related costs for the remainder of the leases associated with the Hayward facility. As of September 30, 2009, the Company made all rent payments associated with the leases and no outstanding restructuring accrual exists.

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

	Facility Closure Costs	Workforce Reduction Costs	Total
Balance, December 31, 2008	$ 80	$ 633	$ 713
Restructuring charges	271	194	465
Payments	(351)	(827)	(1,178)
Balance, September 30, 2009	$ —	$ —	$ —

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 future claims that may be made against the Company, 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.

Line of Credit

On June 29, 2009, the Company entered into a line of credit facility (the "Facility") with Silicon Valley Bank. 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 Facility is unsecured and contains certain financial and non-financial covenants. As of September 30, 2009, the Company was in compliance with these covenants. 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, 2009, the Company has not drawn on the line of credit. The Company incurred $82,000 of Facility origination costs which have been capitalized within prepaid expenses and will be amortized over the 12 month term of the Facility.

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.

Legal Matters

On or about June 18, 2007, Fotomedia Technologies, LLC ("Fotomedia") filed suit in the United States District Court for the Eastern District of Texas, against the Company and several other defendants alleging infringement of U.S. Patent Nos. 6,018,774; 6,542,936 B1; and 6,871,231 B2. Fotomedia sought unspecified damages, costs, interest and attorneys' fees, and a permanent injunction. The court issued a claim construction order on July 21, 2009. Fotomedia and the Company subsequently entered into a settlement agreement and the claims between the parties were dismissed with prejudice on August 20, 2009.

On June 25, 2009, Soverain Software LLC filed a complaint for alleged patent infringement against the Company and seventeen other defendants in Soverain Software LLC. v J.C.Penny Corp. et.al., Civ. No. 6:09-CV-274, in the Eastern District of Texas, Tyler Division. The Complaint asserts infringement of U.S. Patent nos. 5,715,314 and 5,909,492, which claim network sales systems including, among other things, a buyer computer and a shopping cart computer, and U.S. Patent no. 7,272,639, which claims, among other things, a method of processing service requests from a client to a server system through a network using session identifiers. The Complaint asserts that the Company directly or indirectly infringes the patents without providing any details concerning the alleged infringement, and it seeks unspecified damages and injunctive relief. The plaintiff has indicated that it is prepared to offer a license to the patents but the terms of any such license have not been disclosed. The Company has answered the Complaint and asserted affirmative defenses and counterclaims for a declaration of non-infringement, invalidity and unenforceability. The initial Scheduling Conference is set for November 2, 2009.

In addition to the above cases, from time to time, the Company may be involved in various legal proceedings arising in the ordinary course of business. In all cases, at each reporting period, the Company evaluates whether or not a potential loss amount or a potential range of loss is probable and reasonably estimable under the provisions of the authoritative guidance that addresses accounting for contingencies. In such cases, the Company accrues for the amount, or if a range, the Company accrues the low end of the range as a component of legal expense.

Note 8 — Acquisition

On September 10, 2009, the Company acquired all of the outstanding common shares and securities convertible into common shares of TinyPictures, Inc. ("TinyPictures") for a total aggregate purchase price of $1.3 million. The Company also granted $1.3 million in contingent consideration in the form of performance-based restricted stock units ("PBRSUs") to continuing employees. Vesting of the PBRSUs are contingent on achieving certain performance milestones and continued employment. TinyPictures develops applications that enable users to share videos and images to others across mobile networks and social networking platforms. 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. Stock based compensation associated with the PBRSUs will be recognized when the achievement of the performance milestones are deemed probable.

The total purchase price of $1.3 million was reduced for total negative working capital of $0.3 million, resulting in an adjusted purchase price of $1.0 million. Of that amount, $0.1 million was allocated to in-process research and development having an indefinite life and $51,000 was allocated to core technology and user base which will be amortized over their estimated useful lives of one to three years. The Company also recorded a deferred tax asset of $0.6 million which relates to the net operating loss carry-forwards from TinyPictures. The remaining excess purchase price of approximately $0.5 million was allocated to goodwill which represents the knowledge and experience of the assembled workforce and future technology. The results of operations for TinyPictures have been included in the condensed consolidated statement of operations for the period subsequent to the acquisition date. Acquisition-related costs were included in general and administrative expenses in the Company's condensed consolidated statement of operations for the three and nine months ended September 30, 2009.

The following table provides a summary of the activity of the Company's goodwill and intangible asset balances, including additions from the TinyPictures acquisition (in thousands):

	December 31, 2008	Additions	Accumulated Amortization	September 30, 2009
Purchased technology	$ 8,450	$ 128	$ (3,379)	$ 5,199
Customer relationships	990	25	(689)	326
Licenses and other	256	-	(177)	79
Total intangible assets	$ 9,696	$ 153	$ (4,245)	$ 5,604
Goodwill	$ 7,724	$ 544	-	$ 8,268

The following table presents the pro forma statements of operations obtained by combining the historical consolidated statements of operations of the Company and TinyPictures for the three and nine months ended September 30, 2009 and 2008, giving effect to the merger as if it occurred on January 1, 2009 and 2008, respectively (in thousands, except per share data):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008
Pro forma revenue	$ 40,496	$ 35,953	$ 115,385	$ 105,740
Pro forma operating loss	(9,412)	(10,231)	(29,487)	(29,070)
Pro forma net loss	(6,703)	(3,798)	(19,857)	(13,747)
Pro forma basic and diluted net loss per share	$ (0.27)	$ (0.15)	$ (0.78)	$ (0.54)

Note 9 — Restatement

Subsequent to the issuance of its condensed consolidated financial statements for the three and nine months ended September 30, 2008, the Company identified an error in the calculation of its stock-based compensation expense. Since 2006, the Company has licensed software from a third-party to automate the administration of its employee equity programs and calculate its stock based compensation expense. The third-party published a technical bulletin that identified a change to its most current software version to correct computational errors in determining stock-based compensation expense. Subsequently, in 2009 the Company identified that the version of the software it used to calculate stock-based compensation contained the same error and that it had incorrectly calculated stock-based compensation expense by continuing to apply a weighted average forfeiture rate to the vested portion of stock option awards until the grant's final vest date, rather than reflecting actual forfeitures as awards vest. The net effect of the error was an understatement of stock-based compensation expense in certain periods prior to the grant's final vest date. Correction of the financial statement errors will result in changes to the timing of stock-based compensation expense over the vesting period of the awards during the relevant periods, but will not change the total stock-based compensation expense calculated for any grant. As stock-based compensation is a non-cash item, there as no impact to net cash provided or used by operations for the three and nine months of September 30, 2008.

The following is a summary of the significant effects of the restatement:

	Three Months Ended September 30, 2008			Nine Months Ended September 30, 2008		
	As Previously Reported	Adjustments	As Restated	As Previously Reported	Adjustments	As Restated
Net revenues	$35,953	$ -	$35,953	$105,738	$ -	$105,738
Cost of net revenues (1)	18,430	21	18,451	53,739	38	53,777
Gross profit	17,523	(21)	17,502	51,999	(38)	51,961
Operating expenses (1):						
Technology and development	9,645	44	9,689	28,642	154	28,796
Sales and marketing	10,087	51	10,138	26,762	174	26,936
General and administrative	6,772	129	6,901	21,946	353	22,299
Total operating expenses	26,504	224	26,728	77,350	681	78,031
Loss from operations	(8,981)	(245)	(9,226)	(25,351)	(719)	(26,070)
Interest expense	(100)	-	(100)	(185)	-	(185)
Interest and other income, net	455	-	455	2,514	-	2,514
Loss before income taxes	(8,626)	(245)	(8,871)	(23,022)	(719)	(23,741)
Benefit from income taxes	5,915	156	6,071	12,655	377	13,032
Net loss	$(2,711)	$ (89)	$(2,800)	$(10,367)	$ (342)	$(10,709)
Net loss per share - basic and diluted	$(0.11)	$ (0.00)	$(0.11)	$(0.41)	$ (0.02)	$(0.43)
Weighted-average shares outstanding - basic and diluted	25,067	-	25,067	25,020	-	25,020

(1) Stock-based compensation
is allocated as follows:

Cost of net revenues	$88	$ 21	$109	$263	$ 38	$301
Technology and development	610	44	654	1,539	154	1,693
Sales and marketing	645	51	696	1,559	174	1,733
General and administrative	1,087	129	1,216	2,974	353	3,327
	$2,430	$ 245	$2,675	$6,335	$ 719	$7,054

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 twelve 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," "shou "could," "potentially," "will," or "may," or the negative of these terms or other comparable terminology. Forward-lookin 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, stationery and other photo-based products and merchandise.

We currently generate the majority of our net revenues by producing and selling professionally-bound photo books, greeting cards and stationery, personalized calendars, other photo-based merchandise and high-quality prints ranging in size from wallet to jumbo-sized 20x30 enlargements. We currently manufacture these items in our Charlotte, North Carolina and Phoenix, Arizona manufacturing facilities. Our new manufacturing and production facility in Phoenix, Arizona began operations in April 2009, and replaced our Hayward, California facility, which ceased operations in January 2009. 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 periods of peak demand. Additionally, we sell a variety of photo-based merchandise that is currently manufactured for us by third parties, such as calendars, mugs, mouse pads, coasters, tote bags, desk organizers, puzzles, playing cards, multi-media DVDs, magnets, keepsake boxes, notebooks, notepads, address labels and stickers.

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 operations and financial performance depend on general economic conditions. The U.S. economy continues to experience, an economic downturn due to slower economic activity, concerns about inflation, decreased consumer confidence, high consumer debt levels and higher unemployment rates and other adverse business conditions. Such fluctuations in the U.S. economy could cause, among other things, 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 and limited discretionary funds, the economic slowdown could exacerbate the seasonal decline in sales that we typically see in the first three quarters of the calendar year and could negatively effect sales in the fourth quarter, which has historically been the source of a substantial portion of our revenues. Throughout this period we intend to focus on actions that are within our control and initiatives that are intended to increase revenue, earnings, free cash flow and long-term shareholder value.

Basis of Presentation

Net Revenues. We generate revenues primarily from the printing and shipping of photo-based products, such as photo books, cards and stationery, calendars, photo prints, and photo-based merchandise, such as mugs, mouse pads and magnets. 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. Revenue from advertising displayed on our website and 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. We also provide commercial print services which is a component of our net revenues.

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 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 net 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 Sites), and by conducting integrated marketing and advertising programs. Total customers have increased on an annual basis for each year since inception and while we expect this trend to continue, the number of customers is dependent on whether we are successful in executing our strategy in addition to the conditions of the overall economic environment.

Average Order Value. Average order value is net revenues, excluding revenues from our commercial print initiative, 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 as consumers shift from prints into personalized products and services.

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 while we anticipate this trend to continue in the future, the number of orders is dependent on whether we are successful in executing our strategy, the conditions of the overall economic environment and a continued increase in consumer trends towards photo-based products.

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 was 51% in 2006, 56% in 2007 and 61% in 2008. In addition, as a percentage of total net revenues, revenues from 4x6 prints have been declining; from 28% in 2006, to 22% in 2007, and to 19% in 2008.

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 consists 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. Cost of net revenues also includes 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. All of the payments we have received from our intellectual property license agreements have been included as an offset to general and administrative expense. In the nine month period ending September 30, 2009, we received annual payments from two different multi-million dollar cross-licensing agreements. We expect to recognize a final payment due under one of the agreements when it is received in the first quarter of fiscal year 2010.

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

Interest and other income, net. Interest and other income, net consists of the interest earned on our cash and investment accounts as well as gains/losses on our trading securities and the Right from UBS entitling us to sell at par value auction-rate securities purchased from UBS (approximately $48.4 million, par value) at anytime during a two-year period from June 30, 2010 through July 2, 2012.

Income Taxes. Historically, we have only been subject to taxation in the United States because we only operate within the United States.

Critical Accounting Policies and Estimates

The discussion and analysis of our financial condition and results of operations are based upon our unaudited condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. On an on-going basis, we evaluate our critical accounting policies and estimates. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. Our critical accounting policies and estimates are discussed in our Annual Report on Form 10-K-/A for the fiscal year ended December 31, 2008.

Results of Operations

The following table presents the components of our income statement as a percentage of net revenues:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008 (as restated)	2009	2008 (as restated)
Net revenues	100%	100%	100%	100%
Cost of revenues	53%	51%	53%	51%
Gross profit	47%	49%	47%	49%
Operating expenses:				
Technology and development	28%	27%	29%	27%
Sales and marketing	23%	28%	23%	25%
General and administrative	18%	19%	20%	21%
Loss from operations	(22)%	(25)%	(25)%	(24)%
Interest expense	0%	0%	0%	0%
Interest and other income, net	0%	0%	1%	2%
Loss before income taxes	(22)%	(25)%	(24)%	(22)%
Benefit from income taxes	6%	17%	8%	12%
Net loss	(16)%	(8)%	(16)%	(10)%

Comparison of the Three Month Period Ended September 30, 2009 and 2008

	Three Months Ended September 30,			
	2009	2008	$ Change	% Change
	(in thousands)			
		(as restated)		
Net revenues	$40,495	$35,953	4,542	13 %
Cost of net revenues	21,420	18,451	2,969	16 %
Percentage of net revenues	53 %	51 %		
Gross profit	19,075	17,502	1,573	9 %

Net revenues increased $4.5 million, or 13%, for the three months ended September 30, 2009, as compared to the same period in 2008. Revenue growth was attributable to an increase in personalized products and services revenues and revenue from our commercial print initiative, offset by a decrease in print revenue. Personalized products and services (“PPS”) revenues increased $5.5 million, or 28%, to $24.9 million for the three months ended September 30, 2009 as compared to the same period in 2008. The increase in PPS is primarily a result of increased sales of photo books and stationery cards. PPS represented 61% of revenue compared to 54% in the same period in 2008. Revenue from our commercial print initiative totaled $1.2 million, and represented 3% of our total net revenues. Print revenue decreased $0.9 million, or 6%, to $15.6 million for the three months ended September 30, 2009, as compared to the same period in 2008. Print revenue represented 39% of revenue compared to 46% in the same period in 2008. The decrease in overall print revenue is primarily due to a lower average sales price for 4x6 prints which is a result of our price change in September 2008 offset partially by continued stable growth in unit volumes. In the third quarter of 2009, 4x6 print revenues represented 24% of total net revenues versus 29% in the third quarter of 2008.

Excluding commercial print revenues, net revenue increases were also the result of year-over-year increases in all of our key metrics: customers, orders and average order value, as noted below:

	Three Months Ended September 30,			
	2009	2008	$ Change	% Change
	(in thousands, except AOV amounts)			
Customers	982	916	65	7 %
Orders	1,705	1,656	49	3 %
Average order value	$23.03	$21.71	$1.32	6 %

Cost of net revenues increased $3.0 million, or 16%, for the three months ended September 30, 2009 as compared to the same period in 2008. As a percentage of net revenues, cost of net revenues increased from 51% to 53% for the same comparable period, which decreased gross margin from 49% in the third quarter of 2008 to 47% in the third quarter of 2009. The decrease in our gross margin percentage is primarily due to cost increases from the transition of our Hayward manufacturing facility to our new Phoenix manufacturing facility and higher equipment rental expenses compared to the same period in 2008. However, these factors were partially offset by favorable improvements from product mix and continued savings in shipping and materials costs due to operational efficiencies and negotiated cost reductions.

	Three Months Ended September 30,			
	2009	2008	$ Change	% Change
		(in thousands)		
		(as restated)		
Technology and development	$ 11,390	$ 9,689	$ 1,701	18%
Percentage of net revenues	28%	27%		
Sales and marketing	9,377	10,138	(761)	(8)%
Percentage of net revenues	23%	28%		
General and administrative	7,363	6,901	462	7%
Percentage of net revenues	18%	19%		

Our technology and development expense increased $1.7 million, or 18%, for the three months ended September 30, 2009, as compared to the same period in 2008. As a percentage of revenue, this expense increased slightly from 27% to 28% for the same comparable period. The increase in technology and development expense was primarily due to an increase of $0.7 million in third party hosting and connectivity costs compared to the same period in 2008. Depreciation expense also increased by $0.1 million as we continued to invest in our website infrastructure hardware to support our continued revenue growth. Personnel and related costs for employees and consultants involved with website development and website infrastructure support teams increased by $0.4 million. For the three months ended September 30, 2009, we capitalized $1.5 million in eligible costs, which includes $0.4 million of stock based compensation, associated with software developed or obtained for internal use, compared to $1.3 million in the same period in the prior year.

Our sales and marketing expense decreased $0.8 million, or 8%, for the three months ended September 30, 2009 as compared to the same period in 2008. As a percentage of net revenues, sales and marketing expense for the three months ended September 30, 2009 decreased from 28% to 23% for the same comparable period. The decrease in sales and marketing expense is primarily due to a decrease of $1.4 million in customer acquisition costs reflecting greater emphasis on promotional offers and product trials and a reduction in external marketing spend. Overall decrease is offset by an increase of $0.3 million in personnel and related costs primarily due to a slight increase in headcount. In addition, stock base compensation increased by $0.3 million compared to the same period in the prior year.

Our general and administrative expense increased $0.5 million, or 7%, for the three months ended September 30, 2009 as compared to the same period in 2008. As a percentage of net revenues, general and administrative expense decreased from 19% to 18% as compared to the same comparable period. The overall fluctuation in general and administrative expense is primarily due to an increase of $0.8 million in stock based compensation offset by a continued decrease in professional services costs of $0.2 million.

	Three Months Ended September 30,			
	2009	2008	$ Change	% Change
		(in thousands)		
Interest expense	$ (22)	$ (100)	$ (78)	(78)%
Interest and other income, net	74	455	(381)	(84)%

Interest expense decreased by $78,000 or 78% for the three months ended September 30, 2009, as compared to the same periods in 2008, due to the expiration of the line of credit with JP Morgan in April 2009. We completed a replacement facility in June 29, 2009 and incurred lower origination costs resulting in a decrease in amortization expense as compared to the same period in the prior year.

Interest and other income, net decreased by $0.4 million or 84% for the three months ended September 30, 2009, as compared to the same period in 2008. The decrease is primarily due to an overall lower yield on our investment portfolio relative to our investment balances in the comparable prior year period. During the three months ended September 30, 2009, we recorded a $0.9 million mark-to-market gain on our auction-rate securities that have been classified as trading securities which was entirely offset by a $0.9 million loss on the UBS Right.

	Three Months Ended September 30,	
	2009	2008
	(in thousands)	
		(as restated)
Income tax benefit	$ 2,657	$ 6,071
Effective tax rate	30%	68%

The benefit for income taxes was $2.7 million for the three months ended September 30, 2009, compared to the benefit of $6.0 million for the same period in 2008. The decrease in our effective tax rate was primarily the result of the inclusion of federal research and development credits in the three months ended September 30, 2009, compared to same period in the prior year. The Federal Research and Development credit was extended retroactively to January 1, 2008 and prospectively to December 31, 2009 as a result of the Tax Extenders and Alternative Minimum Tax Relief Act of 2008 which was signed into law on October 3, 2008.

As of September 30, 2009, we had approximately $12.1 million of federal and $31 million of state net operating loss carryforwards available to reduce future taxable income. These net operating loss carryforwards begin to expire in 2021 and 2014 for federal and state tax purposes, respectively.

	Three Months Ended September 30,		
	2009	2008	% Change
		(in thousands)	
		(as restated)	
Loss before income taxes	$(9,003)	$ (8,871)	1%
Net loss	(6,346)	(2,800)	127%

Net loss increased by $3.5 million, or 127% for the three months ended September 30, 2009 as compared to the same period in 2008.

Comparison of the Nine Month Period Ended September 30, 2009 and 2008

	Nine Months Ended September 30,			
	2009	2008	$ Change	% Change
	(in thousands)			
		(as restated)		
Net revenues	$ 115,365	$ 105,738	$ 9,627	9%
Cost of net revenues	61,161	53,777	7,384	14%
Percentage of net revenues	53%	51%		
Gross profit	54,204	51,961	2,243	4%

Net revenues increased $9.6 million, or 9% for the nine months ended September 30, 2009 as compared to the same period in 2008. Revenue growth was attributable to the increase in personalized products and services revenues and revenues from our commercial print initiative, offset by a decrease in print revenue. PPS increased $13.6 million, or 24%, to $71.1 million for the nine months ended September 30, 2009 as compared to the same period in 2008. The increase in PPS is primarily a result of increased sales of photo books, stationery cards and calendars. PPS made up 62% of net revenues for the nine months ended September 30, 2009, up from 54% for the same period in 2008. Revenue from our commercial print initiative totaled $2.6 million, and represented 2% of our total net revenues. Print revenue decreased $4.0 million, or 8%, to $44.3 million for the nine months ended September 30, 2009 as compared to the same period in 2008. The decrease in overall print revenue is primarily due to a lower average sales price for 4x6 prints which is a result of our price change in September 2008. The decrease in overall print revenue is also attributable to decreased sales volume of photo card and large format print sizes.

Cost of net revenues increased $7.4 million, or 14%, for the nine months ended September 30, 2009 as compared to the same period in 2008. As a percentage of net revenues, cost of net revenues increased from 51% to 53% for the same comparable period, which decreased gross margin from 49% to 47% for the nine months ended September 30, 2008 and 2009, respectively. The decrease in our gross margin percentage is primarily due to the cost increases from the closure and transition of our Hayward manufacturing facility to our new Phoenix manufacturing facility, an increase in manufacturing headcount, and higher equipment rental expenses compared to the same period in 2008. However, these factors were partially offset by favorable improvements from product mix and continued savings in shipping and materials costs due to operational efficiencies and negotiated cost reductions.

	Nine Months Ended September 30,			
	2009	2008	$ Change	% Change
	(in thousands)			
		(as restated)		
Technology and development	$ 33,347	$ 28,796	$ 4,551	16%
Percentage of net revenues	29%	27%		
Sales and marketing	26,075	26,936	(861)	(3)%
Percentage of net revenues	23%	25%		
General and administrative	22,642	22,299	343	2%
Percentage of net revenues	20%	21%		

Our technology and development expense increased $4.6 million, or 16%, for the nine months ended September 30, 2009 as compared to the same period in 2008. As a percentage of revenue, technology and development expense for the nine months ended September 30, 2009 increased from 27% to 29% for the same comparable period. The increase in technology and development expense was primarily due to an increase of $2.2 million in third party hosting and connectivity costs and an increase in depreciation expense of $0.7 million compared to the same period in 2008. Personnel and related costs for employees and consultants involved with website development and website infrastructure support teams increased by $1.6 million. For the nine months ended September 30, 2009, we capitalized $4.2 million in eligible costs, which includes $1.2 million of stock based compensation, associated with software developed or obtained for internal use, compared to $3.6 million in the same period in the prior year.

Our sales and marketing expense decreased $0.9, or 3%, for the nine months ended September 30, 2009 as compared to the same period in 2008. This expense decreased as a percentage of net revenues from 25% to 23% for the same comparable period. The decrease in sales and marketing expense is primarily due to a decrease of $2.5 million in customer acquisition costs reflecting greater emphasis on promotional offers and product trials and a reduction in external marketing spend. Overall decrease is offset by an increase in personnel and related costs for employees and consultants of $0.9 million and an increase in stock based compensation of $0.7 million compared to the same period in the prior year.

Our general and administrative expense increased $0.3 million, or 2%, for the nine months ended September 30, 2009 as compared to the same period in 2008. This expense decreased as a percentage of net revenues from 21% to 20%. The increase in general and administrative expense is primarily due to increases in facility costs of $0.7 million, depreciation of $0.3 million, and stock-based compensation of $1.5 million. These increases were offset by a $1.7 million decrease in consulting and other professional service costs as a result of a decrease in contractor headcount, as well as decreases in Sarbanes-Oxley related audit expenditures, and ERP costs in the prior year period that did not recur in the current period.

	Nine Months Ended September 30,			
	2009	2008	$ Change	% Change
	(in thousands)			
Interest expense	$ (136)	$ (185)	$ 49	(26)%
Interest and other income, net	681	2,514	(1,833)	(73)%

Interest expense decreased by $49,000 or 26% for the nine months ended September 30, 2009, as compared to the same periods in 2008, due to the expiration of the line of credit with JP Morgan in April 2009. We completed a replacement facility in June 29, 2009 and incurred lower origination costs resulting in a decrease in amortization expense as compared to the same period in the prior year.

Interest and other income, net decreased by $1.8 million or 73% for the nine months ended September 30, 2009, as compared to the same period in 2008. This decrease is primarily due to an overall lower yield on our investment portfolio relative to our investment balances in the comparable prior year periods. During the nine months ended September 30, 2009, we recorded a $2.7 million mark-to-market gain on auction-rate securities that have been classified as trading securities which was entirely offset by a $2.7 million loss on the UBS Right.

	Nine Months Ended September 30,	
	2009	2008
	(in thousands)	
		(as restated)
Income tax benefit	$ 9,083	$ 13,032

Effective tax rate	33%	55%

The benefit for income taxes was $9.1 million for the nine months ended September 30, 2009, compared to benefit of $13.0 million for the same period in 2008. The decrease in our effective tax rate was primarily the result of the inclusion of federal research and development credits in the nine months ended September 30, 2009, compared to same period in the prior year. The Federal Research and Development credit was extended retroactively to January 1, 2008 and prospectively to December 31, 2009 as a result of the Tax Extenders and Alternative Minimum Tax Relief Act of 2008 which was signed into law on October 3, 2008.

	Nine Months Ended September 30,		
	2009	2008	% Change
		(in thousands)	
		(as restated)	
Loss before income taxes	$ (27,315)	$ (23,741)	15%
Net loss	(18,232)	(10,709)	70%

Net loss increased by $7.5 million, or 70%, for the nine months ended September 30, 2009 as compared to the same period in 2008.

Liquidity and Capital Resources

	Nine Months Ended September 30,	
	2009	2008
	(in thousands)	
Consolidated Statements of Cash Flows Data:		
Purchases of property and equipment	$ 8,272	$ 16,760
Capitalization of software and website development costs	3,032	3,239
Depreciation and amortization	20,335	18,833
Net cash flows used in by operating activities	(18,124)	(3,360)
Net cash flows used in investing activities	(8,225)	(79,339)
Net cash flows provided by financing activities	1,435	752

We anticipate that our current cash and cash equivalents balances and cash generated from operations will be sufficient to meet our working capital requirements, capital lease obligations, expansion plans and technology development projects for at least the next twelve months. Whether these resources are adequate to meet 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.

At September 30, 2009, we held approximately $48.4 million par value of variable rate bond investments with a fair value of approximately $42.0 million, classified as short-term investments, with an auction reset feature (“auction rate securities” or "ARS") whose underlying assets are student loans which are substantially backed by the federal government. Since February 2008, these auctions have failed. Therefore the ARS continue to be illiquid and we will not be able to access these funds until a future auction of these investments is successful or a buyer is found outside of the auction process. As a result, our ability to liquidate our investment and fully recover the carrying value of our investment in the near term may be limited or not exist.

During the nine months ended September 30, 2009 the Company liquidated $3.9 million (at par value) ARS investments that were called by the state issuers.

In November 2008, we accepted an offer (the "Right") from UBS AG ("UBS"), one of our investment providers, entitling us to sell at par value ARS purchased from UBS at anytime during a two-year period from June 30, 2010 through July 2, 2012. UBS's obligations under the Right are not secured by its assets and do not require UBS to obtain any financing to support its performance obligations under the Right. UBS has disclaimed any assurance that it will have sufficient financial resources to satisfy its obligations under the Right. If UBS has insufficient funding to buy back the ARS and the auction process continues to fail, then we may incur further losses on the carrying value of the ARS. We do not anticipate that the current illiquidity of these ARS will have a material effect on our cash requirement or working capital.

As of September 30, 2009, we had access to cash and cash equivalents and other liquid investments, totaling $111.6 million. In addition, to supplement our overall liquidity position, we have a 364-day revolving credit facility with a financial institution to provide up to $20.0 million in additional capital resources that expires in June 2010. As of September 30, 2009, no amounts have been drawn against this facility.

We anticipate that total 2009 capital expenditures will range between $19 million to $21 million. 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. Our expenditures also include costs associated with capitalized software and website development. This range of capital expenditures 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, 2009, net cash used in operating activities was $18.1 million, primarily due to our net loss of $18.2 million and the net change in operating assets and liabilities of $30.8 million, adjusted for non-cash items including $20.3 million of depreciation and amortization expense, $0.7 million of deferred income taxes and $9.8 million of stock-based compensation.

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 $10.7 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, $10.1 million of benefit from income taxes and $7.1 million of stock-based compensation.

Investing Activities. For the nine months ended September 30, 2009, net cash used in investing activities was $8.3 million. We used $8.3 million for capital expenditures for computer and network hardware to support our website infrastructure and information technology systems, capital expenditures for production equipment for our manufacturing and production operations, and $3.0 million of capitalized software and website development. We also paid $0.8 million in cash to acquire TinyPictures, Inc. which was based on the adjusted purchase price. The use of cash was offset by cash provided from the liquidation of $3.9 million (at par value) of our ARS investments that were called by the state issuers during the nine months ended September 30, 2009.

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 sale of short term investments. We also paid $10.1 million in cash consideration to acquire Nexo Systems, Inc.

Financing Activities. Our financing activities for the nine months ended September 30, 2009 provided cash of $1.4 million, primarily from $2.1 million in proceeds from issuance of common stock and $0.4 from tax benefit of stock options offset by $1.0 million in cash used to pay employee withholding tax liabilities for restricted shares vested during the period.

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.

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.

Recent Accounting Pronouncements

In February 2008, the FASB issued an accounting standard update that delayed the effective date of fair value measurements accounting for all non-financial assets and non-financial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually), until the beginning of the first quarter of fiscal 2009. These include goodwill and other non-amortizable intangible assets. We adopted this accounting standard update effective January 1, 2009. The adoption of this update to non-financial assets and liabilities, as codified in ASC 820-10 (formerly FSP 157-2, “Effective Date of FASB Statement No. 157”), did not have any impact on our condensed consolidated financial statements.

Effective January 1, 2009, we adopted a new accounting standard update regarding business combinations. As codified under ASC 805 (formerly SFAS No. 141 revised 2007, “Business Combinations”), this update requires an entity to recognize the assets acquired, liabilities assumed, contractual contingencies, and contingent consideration at their fair value on the acquisition date. It further requires that acquisition-related costs be recognized separately from the acquisition and expensed as incurred; that restructuring costs generally be expensed in periods subsequent to the acquisition date; and that changes in accounting for deferred tax asset valuation allowances and acquired income tax uncertainties after the measurement period be recognized as a component of provision for taxes. In addition, acquired in-process research and development is capitalized as an intangible asset and amortized over its estimated useful life. With the adoption of this accounting standard update, any tax related adjustments associated with acquisitions that closed prior to January 1, 2009 will be recorded through income tax expense, whereas the previous accounting treatment would require any adjustment to be recognized through the purchase price. This accounting standard update 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. The adoption of these accounting updates did not have any impact on our condensed consolidated financial statements.

Effective January 1, 2009, we adopted an accounting standard which establishes accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary, as codified in ASC 810-10 (formerly SFAS No. 160, Accounting and Reporting on Non-controlling Interest in Consolidated Financial Statements, an Amendment of ARB 51”). This accounting standard states that accounting and reporting for minority interests are to be recharacterized as noncontrolling interests and classified as a component of equity. The calculation of earnings per share continues to be based on income amounts attributable to the parent. The adoption of these accounting updates did not have any impact on our condensed consolidated financial statements.

Effective January 1, 2009, we adopted an accounting standard update regarding the determination of the useful life of intangible assets. As codified in ASC 350-30-35 (formerly FSP No. 142-3, “Determination of the Useful Life of Intangible Assets”), this update amends the factors considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under intangibles accounting. It also requires a consistent approach between the useful life of a recognized intangible asset under prior business combination accounting and the period of expected cash flows used to measure the fair value of an asset under the new business combinations accounting (as currently codified under ASC 850). The update also requires enhanced disclosures when an intangible asset’s expected future cash flows are affected by an entity’s intent and/or ability to renew or extend the arrangement.

The adoption of these accounting updates did not have any impact on our condensed consolidated financial statements.

Effective January 1, 2009, we adopted a new accounting standard update from the Emerging Issues Task Force ("EITF") consensus regarding the accounting of defensive intangible assets. This update, as codified in ASC 350-30 (formerly EITF No. 08-7, "Accounting for Defensive Intangible Assets"), clarifies accounting for defensive intangible assets subsequent to initial measurement. It applies to acquired intangible assets which an entity has no intention of actively using, or intends to discontinue use of, the intangible asset but holds it to prevent others from obtaining access to it (i.e., a defensive intangible asset). Under this update, a consensus was reached that an acquired defensive asset should be accounted for as a separate unit of accounting (i.e., an asset separate from other assets of the acquirer); and the useful life assigned to an acquired defensive asset should be based on the period during which the asset would diminish in value. The adoption of these accounting updates did not have any impact on our condensed consolidated financial statements.

Effective April 1, 2009, we adopted a new accounting standard for subsequent events, as codified in ASC 855-10 (formerly SFAS No. 165, Subsequent Events). The update modifies the names of the two types of subsequent events either as recognized subsequent events (previously referred to in practice as Type I subsequent events) or non-recognized subsequent events (previously referred to in practice as Type II subsequent events). In addition, the standard modifies the definition of subsequent events to refer to events or transactions that occur after the balance sheet date, but before the financial statements are issued (for public entities) or available to be issued (for nonpublic entities). It also requires the disclosure of the date through which subsequent events have been evaluated. The update did not result in significant changes in the practice of subsequent event disclosures, and therefore the adoption did not have any impact on our condensed consolidated financial statements.

Effective April 1, 2009, we adopted three accounting standard updates which were intended to provide additional application guidance and enhanced disclosures regarding fair value measurements and impairments of securities. They also provide additional guidelines for estimating fair value in accordance with fair value accounting. The first update, as codified in ASC 820-10-65 (formerly FASB Staff Positions ("FSP") No. 157-4, Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly), provides additional guidelines for estimating fair value in accordance with fair value accounting. The second accounting update, as codified in ASC 320-10-65 (formerly FSP No. 115-2, Recognition and Presentation of Other-Than-Temporary Impairments), changes accounting requirements for other-than-temporary-impairment (OTTI) for debt securities by replacing the current requirement that a holder have the positive intent and ability to hold an impaired security to recovery in order to conclude an impairment was temporary with a requirement that an entity conclude it does not intend to sell an impaired security and it will not be required to sell the security before the recovery of its amortized cost basis. The third accounting update, as codified in ASC 825-10-65 (formerly Accounting Principles Board ("APB") Opinion No. 28-1, Interim Disclosures about Fair Value of Financial Instruments), increases the frequency of fair value disclosures. These updates were effective for fiscal years and interim periods ended after June 15, 2009. The adoption of these accounting updates did not have any impact on our condensed consolidated financial statements.

Effective July 1, 2009, we adopted The "FASB Accounting Standards Codification" and the Hierarchy of Generally Accepted Accounting Principles (ASC 105), (formerly SFAS No. 168, The "FASB Accounting Standards Codification" and the Hierarchy of Generally Accepted Accounting Principles). This standard establishes only two levels of U.S. generally accepted accounting principles ("GAAP"), authoritative and nonauthoritative. The Financial Accounting Standard Board ("FASB") Accounting Standards Codification (the "Codification") became the source of authoritative, nongovernmental GAAP, except for rules and interpretive releases of the SEC, which are sources of authoritative GAAP for SEC registrants. All other non-grandfathered, non-SEC accounting literature not included in the Codification became nonauthoritative. We began using the new guidelines and numbering system prescribed by the Codification when referring to GAAP in the third quarter of fiscal 2009. As the Codification was not intended to change or alter existing GAAP, it did not have any impact on our condensed consolidated financial statements.

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 cash equivalents 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.

At September 30, 2009, we held approximately $48.4 million par value of variable rate bond investments with a fair value of approximately $42.0 million, classified as short-term investments, with an auction reset feature ("auction rate securities" or "ARS") whose underlying assets are student loans which are substantially backed by the federal government. Since February 2008, these auctions have failed. Therefore our auction rate securities continue to be illiquid and we will not be able to access these funds until a future auction of these investments is successful or a buyer is found outside of the auction process. As a result, our ability to liquidate our investment and fully recover the carrying value of our investment in the near term may be limited or not exist.

In November 2008, we accepted an offer (the "Right") from UBS AG ("UBS"), one of our investment providers, entitling us to sell at par value auction-rate securities ("ARS") purchased from UBS at anytime during a two-year period from June 30, 2010 through July 2, 2012. UBS's obligations under the Right are not secured by its assets and do not require UBS to obtain any financing to support its performance obligations under the Right. UBS has disclaimed any assurance that it will have sufficient financial resources to satisfy its obligations under the Right. If UBS has insufficient funding to buy back the ARS and the auction process continues to fail, then we may incur further losses on the carrying value of the ARS. We do not anticipate that the current illiquidity of these ARS will have a material effect on our cash requirement or working capital.

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

Evaluation of Disclosure 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, 2009. 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, 2009, our Chief Executive Officer and Chief Financial Officer concluded that, as of such date, the Company’s disclosure controls and procedures were not effective to provide reasonable assurance due to the material weakness described under Management's Report on Internal Control over Financial Reporting (As Restated) in Item 9A of our Annual Report on Form 10-K/A for the year ended December 31, 2008, which the Company is still in the process of remediating. This material weakness is also described below.

A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company’s annual or interim financial statements will not be prevented or detected on a timely basis.

The Company did not maintain effective controls to ensure the completeness and accuracy of stock-based compensation expense. Specifically, the Company did not maintain effective controls to ensure the proper application of forfeiture rates in the calculation of stock-based compensation expense in accordance with generally accepted accounting principles. In October 2009, the Company became aware of a recent alert from it's third party software provider which noted that prior versions of its software did not properly calculate stock-based compensation when users selected the option to use a weighted average forfeiture rate for all tranches of a particular award, as opposed to selecting the option to apply individual forfeiture rates to each tranche. The error was isolated to a single standard report provided in the software package that calculated the stock based compensation to be recorded for a given date range. As a result, when the report was generated, for individual tranches that vested during a stated date range, the stock based compensation expense calculated on the report and associated with that tranche did not equal at least 100 percent of the grant date fair value of the award as required under generally accepted accounting principles.

This material weakness resulted in the restatement of the Company's consolidated financial statements as discussed in Note 12 to the consolidated financial statements included in its Annual Report on Form 10-K/A for the year ended December 31, 2008. Additionally this material weakness could result in a material misstatement to the Company's consolidated financial statements that would not be prevented or detected on a timely basis.

In light of the material weakness referred to above, management performed additional analyses and procedures in order to conclude that the Company's condensed consolidated financial statements included in this Quarterly Report on Form 10-Q are fairly stated in all material respects in accordance with generally accepted accounting principles in the United States of America.

Changes in Internal Control Over Financial Reporting

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, 2009 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Remediation of Material Weakness – Stock-Based Compensation Expense

Subsequent to the identification of the material weakness in October 2009 related to accounting for stock-based compensation expense, the Company has initiated remediation measures relating to the calculation of stock-based compensation expense and the application of the forfeiture rate, which include: (1) adding a control procedure to reperform the calculation of the third-party stock-based compensation software reports; and (2) adding a control procedure to sample grants to verify that cumulative stock-based compensation expense is complete and accurate.

PART II — OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

On or about June 18, 2007, Fotomedia Technologies, LLC (“Fotomedia”) filed suit in the United States District Court for the Eastern District of Texas, against us and several other defendants alleging infringement of U.S. Patent Nos. 6,018,774; 6,542,936 B1; and 6,871,231 B2. Fotomedia sought unspecified damages, costs, interest and attorneys’ fees, and a permanent injunction. The court issued a claim construction order on July 21, 2009. Fotomedia and the Company subsequently entered into a settlement agreement and the claims between the parties were dismissed with prejudice on August 20, 2009.

On June 25, 2009, Soverain Software LLC filed a complaint for alleged patent infringement against us and seventeen other defendants in Soverain Software LLC. v J.C.Penny Corp. et.al., Civ. No. 6:09-CV-274, in the Eastern District of Texas, Tyler Division. The Complaint asserts infringement of U.S. Patent nos. 5,715,314 and 5,909,492, which claim network sales systems including, among other things, a buyer computer and a shopping cart computer, and U.S. Patent no. 7,272,639, which claims, among other things, a method of processing service requests from a client to a server system through a network using session identifiers. The Complaint asserts that we directly or indirectly infringes the patents without providing any details concerning the alleged infringement, and it seeks unspecified damages and injunctive relief. The plaintiff has indicated that it is prepared to offer a license to the patents but the terms of any such license have not been disclosed. We have answered the Complaint and asserted affirmative defenses and counterclaims for a declaration of non-infringement, invalidity and unenforceability. The initial Scheduling Conference is set for November 2, 2009.

In addition to the above cases, from time to time, we may be involved in various legal proceedings arising in the ordinary course of business. In all cases, at each reporting period, we evaluate whether or not a potential loss amount or a potential range of loss is probable and reasonably estimable under the provisions of the authoritative guidance that addresses accounting for contingencies. In such cases, we accrue for the amount, or if a range, we accrue the low end of the range as a component of legal expense.

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 50% of our net revenues for 2008 in the fourth quarter of 2008, and the net income that we generated during the fourth quarter of 2008 was necessary for us to achieve profitability on an annual basis for 2008. In addition, we incur significant additional expenses in the period leading up to the fourth quarter holiday season 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 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 financial performance depend on general economic conditions. The U.S. economy continues to experience an economic downturn, slower economic activity, concerns about inflation, decreased consumer confidence, higher unemployment rates 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 and limited discretionary funds, the economic slowdown could exacerbate the seasonal decline in sales that we typically see in the first three quarters of the calendar year as compared to the fourth quarter and could negatively effect sales in the fourth quarter, which has historically been the source of a substantial portion of our revenues.

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. 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 our financial performance.

Weak economic conditions and declines in consumer spending and consumption have harmed and may further harm our operating results. Purchases of our products are often discretionary. If the economic climate does not improve or continues to deteriorate, customers or potential customers could further 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. In addition, the current economic conditions may lead to price increases by our suppliers or increase our operating expenses due to, among other factors, others, higher costs of labor, energy, equipment and facilities. A continued economic downturn may also lead to additional restructuring actions and associated expenses. For example, during the first quarter of 2009, we reduced our headcount by 5%. Due to reduced consumer spending and increased competitive pressures in the current economic environment, we may not be able to pass these increased costs to our customers. The resulting increased expenses and/or reduced income would negatively impact our operating results.

If the negative macro-economic conditions persist, or if the economy enters a prolonged period of decelerating growth, our results of operations may be further 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 2009 capital expenditures will be between \$19 million and \$21 million. During 2007, we opened a new manufacturing and production plant in Charlotte, North Carolina. In January 2009 we closed our Hayward, California production facility. In April 2009, we opened a new manufacturing and production facility in Phoenix, Arizona. Operational difficulties, such as a significant interruption in the operation 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 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 2008 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 recession and economic slowdown in the U.S. and worldwide and higher inflation, as well as those economic conditions specific to the Internet and e-commerce 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

Global and geopolitical events with indirect economic effects such as pandemic disease, 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 result 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 customer demand and revenues decline or if our expenses exceed our expectations, we may not be able to achieve, sustain or increase profitability on a quarterly or annual basis.

We face many risks, uncertainties, expenses and difficulties relating to increasing our market share and growing our business.

To address the risks and uncertainties of increasing our market share and growing our business, 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 many 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.

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. 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 website operations, offices and customer support centers in Redwood City, California, and production facilities in Charlotte, North Carolina and Phoenix, Arizona. 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.

In 2008 we 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 4x6 print pricing and shipping, may harm our business and results of operations.

Demand for our products and services are sensitive to price, especially in times of economic slowdown and consumer conservatism. Many external factors, including our production and personnel costs, consumer sentiment 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 4x6 prints in order to remain competitive. During the third quarter of 2008, we lowered the list price of 4x6 prints from $0.19 to $0.15. We expect to continue to test other pricing, promotion and bundled service offerings, however, a significant drop in our 4x6 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 17%, 19% and 20% of our net revenues in 2008, 2007 and 2006 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 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;

Photo-related software companies such as Apple, Microsoft and Corel;

Social media companies that host images such as MySpace, Facebook and Hi5; and

Specialized companies in the photo book and stationery business such as Hallmark, American Greetings, Tiny Prints, Picaboo and Blurb.

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. Well-funded competitors may be better able to withstand economic downturns and associated periods of reduced customer spending and increased pricing pressures. 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. Well-funded competitors, 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, 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 fluctuations in the financial markets could adversely affect the value of our assets.

At September 30, 2009, we held approximately $48.4 million par value of variable rate bond investments with a fair value of approximately $42.0 million, classified as short-term investments, with an auction reset feature (“Auction Rate Securities”) whose underlying assets are student loans which are substantially backed by the federal government. Since February 2008, these auctions have failed. Therefore our Auction Rate Securities continue to be illiquid and we will not be able to access these funds until a future auction of these investments is successful or a buyer is found outside of the auction process. As a result, our ability to liquidate our investment and fully recover the carrying value of our investment in the near term may be limited or not exist. During the nine months ended September 30, 2009 the Company liquidated $3.9 million (at par value) auction-rate securities ("ARS") investments that were called by the state issuers.

In November 2008, we accepted an offer (the “Right”) from UBS AG (“UBS”), one of our investment providers, entitling us to sell at par value ARS investments purchased from UBS at anytime during a two-year period from June 30, 2010 through July 2, 2012. If UBS has insufficient funding to buy back the ARS and the auction process continues to fail, then we may incur further losses on the carrying value of the ARS. UBS’s obligations under the Right are not secured by its assets and do not require UBS to obtain any financing to support its performance obligations under the Right. UBS has disclaimed any assurance that it will have sufficient financial resources to satisfy its obligations under the Right.

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.

In 2006, the Board authorized three automatic annual increases to our stock option pool. Each annual increase is limited to a) 4.62% of common stock issued and outstanding on the December 31 immediately prior to the date of increase or b) a lesser number as determined by the Board. After the last annual increase in January 2010, the provision will expire. In order to attract key personnel, the Board authorized 380,000, 135,100 and 200,000 additional inducement stock option grants and restricted stock awards to supplement our option pool which were granted in 2007, 2008 and 2009, respectively. Inducement stock options and awards are granted to certain employees upon hire, which do not require shareholder approval. 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 impacts 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.” 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. In addition, we have noted that unauthorized “spammers” utilize our domain name to solicit spam, which increases the frequency and likelihood that we may be blacklisted.

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 either facility where 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 two third-party hosting facilities in Santa Clara, California, and our production facilities are located in Charlotte, North Carolina and Phoenix, Arizona. 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, 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. 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 continually 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 4x6 prints. We have an agreement with Fuji that expires in April 2010. If that agreement is not renewed before it expires, or 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 of our print and 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 4x6 prints, and photo-based products, such as photo books and calendars, we continually evaluate the demand for new products and services and the need to address these trends. 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, such as our January 2008 acquisition of Nexo and our September 2009 acquisition of TinyPictures. 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 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, pandemic disease (including the influenza virus), 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, 2009, we had 33 patents issued and more than 30 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 to defend, divert management's time and attention, 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 and other trademarks in our major markets of the United States and Canada, as well as in the European Community, Mexico, Japan, Australia, New Zealand, and 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 which was settled in August 2009. In May 2009, we settled a patent infringement suit with Parallel Networks. In June 2009, we were sued by Soverain Software LLC 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. 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.

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.

We collect sales and use taxes in jurisdictions where we have employees and/or property and 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 stock-based compensation activity.

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, our effective tax rate is subject to fluctuations as a result of stock based compensation activity; this includes items such as shortfalls associated with the vesting of restricted stock units and restricted stock awards, disqualifying dispositions when employees exercise and sell their incentive stock options within a two year period, and cancellation of vested non-qualified stock options.

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.

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.

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.

The third party software systems that we utilize to assist us in the calculation and reporting of financial data may contain errors that we may not identify in a timely manner.

We use numerous third party licensed software packages, most notably our equity software and our enterprise resource planning (“ERP”) software, which are complex and fully integrated into our financial reporting. Such third party software may contain errors that we may not identify in a timely manner. If those errors are not identified and addressed timely, our financial reporting may not be in compliance with generally accepted accounting principles.

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. Additional or new regulatory requirements may be adopted in the future. The requirements of existing and potential future 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. In particular, the stock market as a whole recently has experienced extreme price and volume fluctuations that have affected the market price of many technology companies in ways that may have been unrelated to those companies' operating performance. Factors that could cause our stock price to fluctuate include:

Economic downturns and market conditions or trends in our industry or the macro-economy as a whole;

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;

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

Not applicable

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
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).*

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* 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.

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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 30, 2009	By:	/s/ Jeffrey T. Housenbold Jeffrey T. Housenbold President and Chief Executive Officer (Principal Executive Officer)
Dated: October 30, 2009	By:	/s/ Mark J. Rubash Mark J. Rubash Senior Vice President and Chief Financial Officer (Principal Financial Officer)

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