

BLUE NILE INC
Form 10-K
February 28, 2011

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-K**

☐ ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended January 2, 2011

OR

○ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from to

Commission file number 000-50763

Blue Nile, Inc.

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of incorporation or organization)

91-1963165

(I.R.S. Employer Identification No.)

705 Fifth Avenue South, Suite 900

Seattle, Washington 98104

(206) 336-6700

(Address and telephone number, including area code, of principal executive offices)

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	Name of each exchange on which registered
Common Stock, \$.001 Par Value	The NASDAQ Stock Market LLC

Securities registered pursuant to Section 12(g) of the Act:

None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. YES ☐ NO ○

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. YES ○ NO ☐

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 ☐ NO ○

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 during

the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES NO

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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 the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b(2) of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer
Non-accelerated filer Smaller reporting company
(do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES NO

The aggregate market value of the voting stock held by non-affiliates of the registrant at July 4, 2010 was approximately \$627 million, based on the last trading price of \$45.17 per share, excluding approximately 0.4 million shares held by directors and executive officers of the registrant. This calculation does not exclude shares held by organizations whose ownership exceeds 10% of the registrant's outstanding common stock as of July 4, 2010 that have represented on Schedule 13G filed with the Securities and Exchange Commission that they are registered investment advisers or investment companies registered under Section 8 of the Investment Company Act of 1940.

The number of shares outstanding of the registrant's common stock as of February 17, 2011 was 14,573,161.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Company's definitive Proxy Statement to be filed with the Commission pursuant to Regulation 14A in connection with the 2011 Annual Meeting of Stockholders are incorporated by reference into Part III of this Annual Report on Form 10-K.

BLUE NILE, INC.

ANNUAL REPORT ON FORM 10-K FOR THE FISCAL YEAR ENDED JANUARY 2, 2011

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PART I

Item 1. Business

This Annual Report on Form 10-K contains forward-looking statements that involve many risks and uncertainties. These statements, which relate to future events and our future performance, are based on current expectations, estimates, forecasts and projections about the industries in which we operate and the beliefs and assumptions of our management as of the date of this filing. In some cases, you can identify forward-looking statements by terms such as would, could, may, will, should, expect, intend, plan, anticipate, believe, estimate, predict, continue, the negative of these terms or other variations of such terms. In addition, any statements that refer to projections of our future financial performance, our anticipated growth and trends in our business and other characterizations of future events or circumstances, are forward-looking statements. These statements are only predictions based upon assumptions made that are believed to be reasonable at the time, and are subject to risk and uncertainties. Therefore, actual events or results may differ materially and adversely from those expressed in any forward-looking statement. In evaluating these statements, you should specifically consider the risks described under the caption Item 1A Risk Factors and elsewhere in this Form 10-K. These factors, and other factors, may cause our actual results to differ materially from any forward-looking statements. Except as required by law, we undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

Overview

Incorporated in 1999 as a Delaware corporation, Blue Nile is the leading online retailer of high quality diamonds and fine jewelry. Our mission is to create a better way for consumers to purchase diamonds and fine jewelry. We offer an exceptional customer experience including substantial education, guidance, selection, customization capability, convenience and value. We have successfully built Blue Nile into a premium brand. Our principal corporate offices are located in Seattle, Washington.

We have three wholly-owned subsidiaries: Blue Nile, LLC (LLC), Blue Nile Worldwide, Inc. (Worldwide) and Blue Nile Jewellery, Ltd. (Jewellery). LLC serves our customers in the United States, Canada and Asia-Pacific. Worldwide serves customers in the European Union, and Jewellery operates a customer service and fulfillment center in Dublin, Ireland.

We derive our revenues through our three websites: www.bluenile.com, www.bluenile.ca and www.bluenile.co.uk. Our primary website serves the U.S. and 14 additional countries and territories throughout the world. All member states of the European Union (E.U.) are served from our United Kingdom (U.K.) website and Canadian customers are supported from our Canada website. Our domestic sales consist of products delivered to customers within the U.S. and our international sales consist of products delivered to customers outside the U.S. Financial information by geographic area is included in Note 11 to the consolidated financial statements in Item 8 of this Annual Report on Form 10-K.

We have built a well respected consumer brand by employing an informative sales process that empowers our customers while offering a broad selection of high quality jewelry at very competitive prices. Our websites showcase tens of thousands of independently certified diamonds and styles of fine jewelry, including rings, wedding bands, earrings, necklaces, pendants, bracelets and watches. We specialize in the customization of diamond jewelry with our Build Your Own feature that offers customers the ability to customize diamond rings, pendants and earrings. We have developed an efficient online cost structure and a unique supply solution that eliminates traditional layers of diamond wholesalers and brokers, which generally allow us to purchase most of our product offerings at lower prices by

avoiding mark-ups imposed by those intermediaries. While we may selectively acquire diamond inventory that we believe will be attractive to our customers, our supply solution enables us to purchase only those diamonds that our customers have ordered. As a result, we are able to minimize the costs associated with carrying diamond inventory and limit our risk of potential mark-downs.

The importance of a purchase of diamonds and fine jewelry leads consumers to seek out substantial information and trusted guidance throughout their purchasing process. Our comprehensive websites and

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expertly trained customer service representatives (diamond and jewelry consultants) improve the traditional purchasing experience by providing education and detailed product information that enable our customers to objectively compare diamonds and fine jewelry products, and make informed decisions. Our websites feature an interactive search functionality that allows our customers to quickly find the products that meet their needs from our broad selection of diamonds and fine jewelry.

Business Strategies

Our objective is to maximize our revenue and profitability and increase market share both domestically and internationally by offering exceptional value to our customers through a high quality customer experience that leverages supply chain efficiencies and an efficient cost structure. We have established and will continue to refine our scalable, capital-efficient business model that enables growth with lower working capital requirements than traditional store-based jewelry retailers. We focus on optimizing the cash flow dynamics of our business by managing inventory balances along with vendor payment terms. Over the longer term, our goal is to increase revenues, profit, and cash flow by leveraging our relatively fixed cost technology and operations infrastructure as we achieve sales increases.

Blue Nile's Product Offerings and Supplier Relationships

Our merchandise consists of high quality diamonds and fine jewelry, with a particular focus on engagement diamonds and settings. Our online business model, combined with the strength of our supplier relationships, enables us to pursue a dynamic merchandising strategy. Our exclusive diamond supplier relationships allow us to display suppliers' diamond inventories on the Blue Nile websites for sale to consumers without holding the diamonds in our inventory until the products are ordered by customers. We purchase polished diamonds from several dozen suppliers, many of whom have long-standing relationships with us. We typically enter into multi-year agreements with diamond suppliers that provide for certain diamonds to be offered exclusively online to consumers through the Blue Nile websites. Our diamond supply agreements have expiration dates ranging from 2011 to 2015. Our diamond suppliers purchase rough and polished diamonds from sources throughout the world. Their ability to supply us with diamonds is dependent upon their ability to procure these diamonds.

While we currently offer over 70,000 independently certified diamonds, we aim to limit our diamond offerings to those possessing characteristics associated with high quality. Accordingly, we offer diamonds with specified characteristics in the areas of shape, cut, color, clarity and carat weight.

We generally purchase diamonds on a just in time basis from our suppliers when a customer places an order for a specific diamond. We then assemble the diamond with a ring, pendant or earring setting from our inventory into customized diamond jewelry according to our customer's specifications. The finished jewelry is delivered to the customer generally within three business days from the order date and within one business day for Blue Nile Signature diamonds.

We offer a broad range of other fine jewelry products and watches to complement our selection of high quality customized diamond jewelry. Our fine jewelry selection includes diamond, gemstone, platinum, gold, pearl and sterling silver jewelry and accessories as well as settings, wedding bands, earrings, necklaces, pendants and bracelets. In the case of fine jewelry, unlike most diamonds that we sell, we typically take products into inventory before they are ordered by our customers. Our fine jewelry and watches are purchased from over 50 manufacturers, most of whom have long-standing relationships with us. We do not enter into long-term supply agreements with our fine jewelry and watch vendors. We do enter into purchase order agreements with suppliers of fine jewelry and watches. These purchase order agreements establish terms for quantity, price, payment and shipping. Additionally, we enter into operating agreements with these suppliers that include product quality requirements, product specifications and shipping procedures. We believe that our current suppliers are able to sufficiently meet our product needs and that

there are alternative sources for most fine jewelry and watch items that we purchase.

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Marketing

Our marketing strategy is designed to increase Blue Nile brand recognition, generate consumer traffic, acquire customers, build a loyal customer base and promote repeat purchases. We believe our customers generally seek high quality diamonds and fine jewelry from a trusted source in a non-intimidating environment, where information, guidance, reputation, convenience and value are important characteristics. Our marketing and advertising efforts include online and offline initiatives, which primarily consist of search engines, portals and targeted website advertising, affiliate programs, direct online marketing, online shopping clubs, social networking and public relations.

Customer Service and Support

A key element of our business strategy is our ability to provide a high level of customer service and support. We augment our online information resources with knowledgeable, highly trained support staff through our call centers to give customers confidence in their purchases. Our diamond and jewelry consultants are trained to provide guidance on all steps in the process of buying diamonds and fine jewelry, including, among other things, the process for selecting an appropriate item, the purchase of that item, financing and payment alternatives, and shipping services. Our commitment to customers is reflected in both high service levels that are provided by our extensively trained diamond and jewelry consultants, as well as in our guarantees and policies. We prominently display all of our guarantees and policies on our websites to create an environment of trust. These include policies relating to privacy, security, product availability, pricing, shipping, refunds, exchanges and special orders. We typically offer a return policy of 30 days. We generally do not extend credit to customers except through third-party credit cards, although we maintain a relationship with a consumer financing company that offers financing to our customers.

Fulfillment Operations

Our fulfillment operations are designed to enhance value for our customers by fulfilling orders quickly, securely and accurately. When an order for a customized diamond jewelry setting is received, the third-party supplier who holds the diamond in inventory generally ships it to us, or to independent third-party jewelers with whom we maintain ongoing relationships for assembly, within one business day. Upon receipt, the merchandise is sent to assembly for setting and sizing, which is performed by our jewelers or independent third-party jewelers. Each diamond is inspected upon arrival from our suppliers, and each finished product is inspected prior to shipment to a customer. Prompt and secure delivery of our products is a high priority, and we ship nearly all diamond and fine jewelry products via nationally recognized carriers. Loose diamonds and customized diamond jewelry products may be shipped by Blue Nile or directly by our suppliers or third-party jewelers to our customers.

Technology and Systems

Our technology systems use a combination of proprietary, licensed and open-source technologies. We focus our internal development efforts on creating and enhancing the features and functionality of our websites and order processing and fulfillment systems to deliver a high quality customer experience. We license third-party information technology systems for our financial reporting, inventory management, order fulfillment and merchandising. We use redundant Internet carriers to minimize the risk of downtime. Our systems are monitored continuously using third-party software, and an on-call team is staffed to respond to any emergencies or unauthorized access in the technology infrastructure.

Seasonality

We generally experience seasonal fluctuations in demand for our products. Our quarterly sales are impacted by various gift giving holidays including Valentine's Day (first quarter), Mother's Day (second quarter) and Christmas

(fourth quarter). As a result, our quarterly revenue is generally the lowest in the third quarter (as a result of the lack of recognized gift giving holidays) and highest in the fourth quarter. The fourth

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quarter accounted for approximately 34%, 34% and 29% of our net sales in the years ended January 2, 2011, January 3, 2010 and January 4, 2009, respectively.

Competition

The diamond and fine jewelry retail market is intensely competitive and highly fragmented. Our primary competition comes from online and offline retailers that offer products within the higher quality segment of the jewelry market. In the future, we may also compete with other retailers that move into the higher quality jewelry segment. Current or potential competitors include the following:

- independent jewelry stores,
- retail jewelry store chains,
- online retailers that sell jewelry,
- department stores, chain stores and mass retailers,
- online auction sites,
- catalog and television shopping retailers,
- discount superstores and wholesale clubs, and
- Internet shopping clubs.

In addition to these competitors, we may face competition from suppliers of our products that decide to sell directly to consumers, either through physical retail outlets or through an online store. We also face competition from entities that make and market synthetic stones and gems to compete in the market for diamonds and diamond jewelry.

We believe that the principal competitive factors in our market are product selection and quality, customer service and support, price, brand recognition, reputation, reliability and trust, website features and functionality, convenience, and delivery performance. We believe that we compete favorably in the market for diamonds and fine jewelry by focusing on these factors.

Intellectual Property

We rely on general intellectual property law and contractual restrictions and, to a limited extent, copyrights and patents, to protect our proprietary rights and technology. These contractual restrictions include confidentiality agreements, invention assignment agreements and nondisclosure agreements with employees, contractors, suppliers and strategic partners. Despite the protection of general intellectual property law and our contractual restrictions, it may be possible for a third-party to copy or otherwise obtain and use our intellectual property without our authorization. In addition, we pursue the registration of our trademarks and service marks in the U.S. and certain other countries. However, effective intellectual property protection or enforcement may not be available in every country in which our products and services are made available in the future. In the U.S. and certain other countries, we have registered Blue Nile, bluenile.com, the BN logo, the Blue Nile BN stylized logo and Build Your Own Ring as trademarks. We have also registered copyrights with respect to images and information set forth on our websites and the computer codes incorporated in our websites, and filed U.S. patent applications relating to certain features of our websites. We also rely on technologies that we license from third parties, particularly software solutions for financial

reporting, inventory management, order fulfillment and merchandising.

Employees

At January 2, 2011, we employed 191 full-time employees and two part-time employees. We also utilize temporary personnel on a seasonal basis. Our employees are not party to any collective bargaining agreement and we have never experienced an organized work stoppage. We believe our relations with our employees are good.

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Available Information

We make available, free of charge, through our primary website, www.bluenile.com, our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and any amendments to those reports as soon as reasonably practicable after electronically filing such material with or furnishing it to the Securities and Exchange Commission (SEC). Our SEC reports, as well as our corporate governance policies and code of ethics, can be accessed through the investor relations section of our website. The information found on our website is not part of this or any other report filed with or furnished to the SEC. All of our filings with the SEC may be obtained at the SEC's Public Reference Room at 100 F Street, NE, Washington, DC 20549. For information regarding the operation of the SEC's Public Reference Room, please contact the SEC at 1-800-SEC-0330. Additionally, the SEC maintains an Internet site that contains reports, proxy and information statements and other information regarding issuers that file electronically with the SEC at www.sec.gov. Amendments to, and waivers from, the code of ethics that apply to our principal executive officer, principal financial officer and principal accounting officer, or persons performing similar functions, and that relates to any element of the code of ethics definition enumerated in Item 406(b) of Regulation S-K will be disclosed at the website address provided above and, to the extent required by applicable regulations, on a current report on Form 8-K.

Item 1A. Risk Factors

You should carefully consider the risks described below and elsewhere in this report, which could materially and adversely affect our business, results of operations or financial condition. Our business faces significant risks and the risks described below may not be the only risks we face. Additional risks not presently known to us or that we currently believe are immaterial may materially affect our business, results of operations, or financial condition. If any of these risks occur, the trading price of our common stock could decline and you may lose all or part of your investment.

General economic factors may materially and adversely affect our financial performance and results of operations.

Our financial performance and results of operations depend significantly on worldwide economic conditions and their impact on consumer spending. Luxury products, such as diamonds and fine jewelry, are discretionary purchases for consumers. Recessionary economic cycles, higher interest rates, higher fuel and energy costs, inflation, levels of unemployment, conditions in the residential real estate and mortgage markets, access to credit, consumer debt levels, unsettled financial markets, and other economic factors that may affect consumer spending or buying habits could materially and adversely affect demand for our products. In addition, the recent turmoil in the financial markets has had and may continue to have an adverse effect on the United States and world economies, which could negatively impact consumer spending patterns for the foreseeable future. A decline in the number of marriages or reductions in consumer spending or disposable income may affect us more significantly than companies in other industries and companies with a more diversified product offering. In addition, negative global economic conditions may materially and adversely affect our suppliers' financial performance, liquidity and access to capital. This may affect their ability to maintain their inventories, production levels and/or product quality, and could cause them to raise prices, lower production levels or cease their operations.

Further, any reduction in our sales will affect our liquidity. As discussed under "Liquidity and Capital Resources" in Part II, Item 7 of this Form 10-K, our liquidity is primarily dependent upon our net cash from operating activities. Our net cash from operating activities is sensitive to many factors, including changes in working capital. Working capital at any specific point in time is dependent upon many variables, including our operating results, seasonality, inventory management and assortment expansion, the timing of cash receipts and payments, and vendor payment terms.

Although we do not anticipate needing additional capital in the near term, financial market disruption may make it difficult for us to raise additional capital, when needed, on acceptable terms or at all. The interest

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rate environment and general economic conditions could also impact the investment income we are able to earn on securities we may hold from time to time.

The prices of commodity products upon which we are substantially dependent, such as diamonds, colored gemstones, platinum, gold and silver, are subject to fluctuations arising from changes in supply and demand, competition and market speculation. Rapid and significant changes in commodity prices, particularly diamonds, may materially and adversely affect our sales and profit margins by increasing the prices for our products. Economic factors such as increased shipping costs, inflation, higher costs of labor, insurance and healthcare, and changes in other laws, regulations, and taxes may also increase our cost of sales and our selling, general and administrative expenses, and otherwise adversely affect our financial condition and results of operations.

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

We expect our net sales and operating results to vary significantly from quarter to quarter due to a number of factors, including changes in:

- demand for our products;
- the costs to acquire quality diamonds and precious metals;
- our ability to attract visitors to our websites and convert those visitors into customers;
- general economic conditions, both domestically and globally;
- our ability to retain existing customers or encourage repeat purchases;
- our ability to manage our product mix and inventory;
- wholesale diamond prices;
- consumer tastes and preferences for diamonds and fine jewelry;
- advertising and other marketing costs;
- our, or our competitors' pricing and marketing strategies;
- the introduction of competitive websites, products, price decreases or improvements;
- conditions or trends in the diamond and fine jewelry industry;
- conditions or trends in the Internet and e-commerce industry;
- the success of our geographic, service and product line expansions;
- our ability to manage our operations;
- the extent to which we provide for and pay taxes;

stock-based compensation expense as a result of the nature, timing and amount of stock options and restricted stock units granted, the underlying assumptions used in valuing stock options, the estimated rate of stock option and restricted stock unit forfeitures and other factors;

foreign exchange rates;

interest rates; and

costs of expanding or enhancing our technology or websites.

As a result of the variability of these and other factors, our operating results in future quarters may be below the expectations of public market analysts and investors. In this event, the price of our common stock may decline.

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As a result of seasonal fluctuations in our net sales, our quarterly results may fluctuate and could be below expectations.

We have experienced and expect to continue to experience seasonal fluctuations in our net sales. In particular, a disproportionate amount of our net sales has been realized during the fourth quarter as a result of the December holiday season, and we expect this seasonality to continue in the future. Approximately 34%, 34% and 29% of our net sales in the years ended January 2, 2011, January 3, 2010 and January 4, 2009, respectively, were generated during the fourth quarter of each year. In anticipation of increased sales activity during the fourth quarter, we may incur significant additional expenses, including higher inventory of fine jewelry and additional staffing in our fulfillment and customer support operations. If we experience lower than expected net sales during any fourth quarter, it may have a disproportionately large impact on our operating results and financial condition for that year. Further, we may experience an increase in our net shipping cost due to complimentary upgrades, split-shipments, and additional long-zone shipments necessary to ensure timely delivery for the holiday season. We also experience considerable fluctuations in net sales in periods preceding other annual occasions such as Valentine's Day and Mother's Day. In the future, our seasonal sales patterns may become more pronounced, may strain our personnel and fulfillment activities, and may cause a shortfall in net sales as compared with expenses in a given period, which could substantially harm our business and results of operations.

We may not accurately forecast net sales and appropriately plan our expenses.

We may base our current and future expense levels on our operating forecasts and estimates of future net sales. Net sales and operating results are difficult to forecast because they generally depend on the volume and timing of the orders we receive, which are uncertain. Additionally, our business is affected by general economic and business conditions in the U.S. and international markets. A softening in net sales, whether caused by changes in customer preferences or a weakening in the U.S. or global economies, may result in decreased revenue levels. Some of our expenses are fixed, and as a result, we may be unable to adjust our spending in a timely manner to compensate for any unexpected shortfall in net sales. This inability could cause our net income in a given quarter to be lower than expected. We also make certain assumptions when forecasting the amount of expense we expect related to our stock-based compensation, which includes the expected volatility of our stock price, the expected life of options granted and the expected rate of stock option and restricted stock unit forfeitures. These assumptions are partly based on historical results. If actual results differ from our estimates, our net income in a given quarter may be lower than expected.

Our failure to acquire quality diamonds and fine jewelry at commercially reasonable prices and lead times would result in higher costs and damage our operating results and competitive position.

Our high quality customer experience depends on our ability to provide expeditious fulfillment of customer orders. If we are unable to acquire quality diamonds and fine jewelry at commercially reasonable prices and lead times, our costs may exceed our forecasts, our gross margins and operating results and customer experience may suffer and our competitive position could be damaged. The success of our business model depends, in part, on our ability to offer quality products to customers at prices that are below those of traditional jewelry retailers. Because of our virtual inventory model, our prices are much more sensitive to rapid fluctuations in the prices of commodities, particularly diamonds, which traditional retailers hold in inventory.

A majority of the world's supply of rough diamonds is controlled by a small number of diamond mining firms. As a result, any decisions made to restrict the supply of rough diamonds by these firms to our suppliers could substantially impair our ability to acquire diamonds at commercially reasonable prices, if at all. We do not currently have any direct supply relationships with these firms. Our ability to acquire diamonds and fine jewelry is also substantially dependent on our relationships with various suppliers. Approximately 28%, 24% and 22% of our payments to our diamond and

fine jewelry suppliers for each of the years ended January 2, 2011, January 3, 2010 and January 4, 2009 were made to our top three suppliers for that year. Our inability to maintain and expand these and other future diamond and fine jewelry supply relationships on commercially reasonable terms or the inability of our current and future suppliers to maintain arrangements for the supply of

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products sold to us on commercially reasonable terms would substantially harm our business and results of operations. The financial performance and viability of our suppliers are also significantly dependent upon worldwide economic conditions and consumer demand for diamonds and fine jewelry. The failure of any of our principal suppliers to remain financially viable could adversely impact our supply of diamonds and fine jewelry for sale to our customers.

Suppliers and manufacturers of diamonds as well as retailers of diamonds and diamond jewelry are vertically integrated and we expect they will continue to vertically integrate their operations either by developing retail channels for the products they manufacture or acquiring sources of supply, including, without limitation, diamond mining operations. To the extent such vertical integration efforts are successful, some of the fragmentation in the existing diamond supply chain could be eliminated, our ability to obtain an adequate supply of diamonds and fine jewelry from multiple sources could be limited and our competitors may be able to obtain diamonds at lower prices.

Our failure to meet customer expectations with respect to price would adversely affect our business and results of operations.

Demand for our products has been highly sensitive to pricing changes. Changes in our pricing strategies have had and may continue to have a significant impact on our net sales, gross margins and net income. In the past, we have instituted retail price changes as part of our strategy to stimulate growth in net sales and optimize gross profit. We may institute similar price changes in the future. Such price changes may not result in an increase in net sales or in the optimization of gross profits. In addition, many external factors, including the costs to acquire diamonds and precious metals and our competitors' pricing and marketing strategies, can significantly impact our pricing strategies. If we fail to meet customer expectations with respect to price in any given period, our business and results of operations would suffer.

We may not succeed in sustaining and promoting the Blue Nile brand, which would prevent us from acquiring customers and increasing our net sales.

A significant component of our business strategy is the continued establishment and promotion of the Blue Nile brand. Due to the competitive nature of the market for diamonds and fine jewelry, if we do not sustain and promote our brand and branded products, we may fail to build the critical mass of customers required to substantially increase our net sales. Promoting and positioning our brand will depend largely on the success of our marketing and merchandising efforts and our ability to provide a consistent, high quality product and customer experience. To promote our brand and products, we have incurred and will continue to incur substantial expenses related to advertising and other marketing efforts. These expenses may not result in increased consumer demand for our products, which would negatively impact our financial results.

A critical component of our brand promotion strategy is establishing a relationship of trust with our customers, which we believe can be achieved by providing a high quality customer experience. In order to provide a high quality customer experience, we have invested and will continue to invest substantial amounts of resources in the development and functionality of our multiple websites, technology infrastructure, fulfillment operations and customer service operations. Our ability to provide a high quality customer experience is also dependent, in large part, on external factors over which we may have little or no control, including, without limitation, the reliability and performance of our suppliers, third-party jewelry assemblers, third-party carriers, third party diamond grading labs, and networking vendors. During our peak seasons, we rely on temporary employees to supplement our full-time customer service and fulfillment employees. Temporary employees may not have the same level of commitment to our customers as our full-time employees. If our customers are dissatisfied with the quality of the products or the customer service they receive, or if we are unable to deliver products to our customers in a timely manner or at all, our customers may stop purchasing products from us. We also rely on third parties for information, including product characteristics and availability that we present to consumers on our websites, which may, on occasion, be inaccurate.

Our failure to provide our customers with high quality products and high quality customer experiences for any reason could substantially harm our reputation and adversely impact our efforts to develop Blue Nile as a trusted brand. The failure of our brand promotion activities could adversely affect our ability to

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attract new customers and maintain customer relationships, and, as a result, substantially harm our business and results of operations.

We face significant competition and may be unsuccessful in competing against current and future competitors.

The retail jewelry industry is intensely competitive and online retail is rapidly evolving and subject to changing technology, shifting consumer preferences and tastes, and frequent introductions of new products and services. We expect the competition in the sale of diamonds and fine jewelry to increase and intensify in the future. Our current and potential competitors range from large and established companies to emerging start-ups. Larger more established companies have longer operating histories, greater brand recognition, existing customer and supplier relationships, and significantly greater financial marketing and other resources. Additionally, larger competitors seeking to establish an online presence may be able to devote substantially more resources to website systems development and exert more leverage over the supply chain for diamonds and fine jewelry than we can. Larger competitors may also be better capitalized to opportunistically acquire, invest or partner with other domestic and international businesses.

Emerging start-ups may be able to innovate and provide products and services faster than we can. In addition, competitors that are traditional store based retailers offer consumers the ability to physically handle and examine products in a manner that is not possible over the Internet, as well as a more convenient means of returning and exchanging purchased products. If our competitors are more successful than we are in offering compelling products or in attracting and retaining consumers, our revenues and growth rates could decline. Furthermore, in recent years, competitors have reduced the retail price of their diamonds and fine jewelry as a result of lack of consumer demand and/or inventory liquidations. Such reductions and/or inventory liquidations can have a short-term adverse effect on our sales. Current and potential competitors include:

independent jewelry stores;

retail jewelry store chains, such as Tiffany & Co.;

online retailers that sell jewelry, such as Amazon.com;

department stores, chain stores and mass retailers, such as Nordstrom and Neiman Marcus;

online auction sites, such as eBay;

catalog and television shopping retailers, such as Home Shopping Network and QVC;

discount superstores and wholesale clubs, such as Wal-Mart and Costco Wholesale; and

Internet shopping clubs, such as Gilt Groupe and Rue La La.

In addition to these competitors, we may face competition from suppliers of our products that decide to sell directly to consumers, either through physical retail outlets or through online stores. We also face competition from entities that make and market synthetic stones and gems to compete in the market for diamonds and diamond jewelry.

We may be unsuccessful in further expanding our operations internationally.

For the year ended January 2, 2011, international net sales represented 13% of our total net sales. In 2010, we continued to increase marketing and sales efforts throughout Europe, Canada and the Asia-Pacific region, and anticipate continuing to expand our international sales and operations in the future either by expanding local versions

of our website for foreign markets or through acquisitions or alliances with third parties. Any international expansion plans we choose to undertake will increase the complexity of our business, require attention from management and other personnel and cause additional strain on our operations, technology systems, financial resources, and our internal financial control and reporting functions. Further, our expansion efforts may be unsuccessful. We have limited experience selling our products in international markets and in conforming to the local cultures, standards or policies necessary to successfully compete in those markets. We cannot be certain that we will be able to expand our global presence if we choose to further

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expand internationally. In addition, we may have to compete with retailers that have more experience with local markets. Our ability to expand and succeed internationally may also be limited by the demand for our products, the ability to successfully transact in foreign currencies, the ability of our brand to resonate with consumers globally and the adoption of electronic commerce in these markets. Different privacy, censorship and liability standards and regulations, and different intellectual property laws in foreign countries may prohibit expansion into such markets or cause our business and results of operations to suffer.

Our current and future international operations may also fail to succeed due to other risks inherent in foreign operations, including:

- the need to develop new supplier and jeweler relationships;
- international regulatory requirements, tariffs and duties;
- difficulties in staffing and managing foreign operations;
- longer payment cycles from credit card companies;
- greater difficulty in accounts receivable collection;
- our reliance on third-party carriers for product shipments to our customers;
- risk of theft of our products during shipment;
- limited shipping and insurance options for us and our customers;
- potential adverse tax consequences;
- foreign currency exchange risk;
- lack of infrastructure to adequately conduct electronic commerce transactions or fulfillment operations;
- unclear foreign intellectual property protection laws;
- laws and regulations related to corporate governance and employee/employer relationships;
- price controls or other restrictions on foreign currency;
- difficulties in obtaining export, import or other business licensing requirements;
- changes in customs and import processes, costs or restrictions;
- increased payment risk and greater difficulty addressing credit card fraud;
- consumer and data protection laws;
- lower levels of adoption or use of the Internet;
- geopolitical events, including war and terrorism; and

the need to conduct business in foreign languages on both the website and in our customer service efforts.

Our failure to successfully expand and manage our international operations may cause our business and results of operations to suffer.

If the single facility where substantially all of our computer and communications hardware is located fails, our business, results of operations and financial condition 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 websites is located at a single leased facility. Our systems and operations are vulnerable to damage or interruption from human error, fire, flood, power loss, telecommunications failure, terrorist attacks, acts of war, break-ins, earthquake and similar events. We do not

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presently have redundant systems in multiple locations and our business interruption insurance may be insufficient to compensate us for losses that may occur.

Our systems are vulnerable to security breaches.

Our technology systems may be breached due to the actions of outside parties, employee error, malfeasance, or otherwise, and, as a result, an unauthorized third party may obtain access to our confidential data or our customers data. Additionally, outside parties may attempt to fraudulently induce employees, users, or customers to disclose sensitive information in order to obtain access to our data or our customers data. Any such breach or unauthorized access could result in significant legal and financial exposure, damage to our reputation, and a loss of confidence in the security of our products and services that could potentially have an adverse effect on our business and results of operations. Because the techniques used to obtain unauthorized access, disable or degrade service, or sabotage systems change frequently and often are not recognized until launched against a target, we may be unable to anticipate these techniques or to implement adequate preventative measures.

If our fulfillment operations are interrupted for any significant period of time, our business and results of operations would be substantially harmed.

Our success depends on our ability to successfully receive and fulfill orders and to promptly and securely deliver our products to our customers. Most of our inventory management, jewelry assembly, packaging, labeling and product return processes are performed in a single fulfillment center located in the United States. We also have a fulfillment facility located in Ireland. These facilities are susceptible to damage or interruption from human error, fire, flood, power loss, telecommunications failure, terrorist attacks, acts of war, break-ins, earthquake and similar events. Our business interruption insurance may be insufficient to compensate us for losses that may occur in the event operations at our fulfillment centers are interrupted. Any interruptions in our fulfillment center operations for any significant period of time could damage our reputation and brand and substantially harm our business and results of operations.

We rely on our suppliers, third-party carriers and third-party jewelers as part of our fulfillment process, and these third parties may fail to adequately serve our customers.

We significantly rely on our suppliers to promptly ship us diamonds ordered by our customers. Any failure by our suppliers to sell and ship such products to us in a timely manner will have an adverse effect on our ability to fulfill customer orders and harm our business and results of operations. Our suppliers, in turn, rely on third-party carriers to ship diamonds to us, and in some cases, directly to our customers. We also rely on a limited number of third-party carriers to deliver inventory to us and product shipments to our customers. We and our suppliers are therefore subject to the risks, including employee strikes, inclement weather, power outages, national disasters, rising fuel costs and financial constraints associated with such carriers abilities to provide delivery services to meet our and our suppliers shipping needs. In addition, for some customer orders we rely on third-party jewelers to assemble and ship the product. Our suppliers, third-party carriers or third-party jewelers failure to deliver high-quality products to us or our customers in a timely manner or to otherwise adequately serve our customers would damage our reputation and brand and substantially harm our business and results of operations.

If we do not continuously innovate in response to the changing preferences of our customers, our business could be adversely affected.

The number of people who access the internet through devices other than personal computers, including mobile phones, smart phones, handheld computers such as notebooks and tablets, video game consoles, and television set-top devices, has increased dramatically in the past few years. The lower resolution, functionality, and memory associated with some alternative devices may make the use of our website and the purchasing our products more difficult; and

the versions of our websites developed for these devices may not be compelling to consumers. Each manufacturer or distributor may establish unique technical standards for its devices, and our website may not work or be viewable on these devices as a result. We have limited experience to date in

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developing and optimizing our website for users of alternative devices. As new devices and new platforms are continually being released, it is difficult to predict the problems we may encounter in developing versions of our website for use on these alternative devices and we may need to devote significant resources to the creation, support, and maintenance of such devices. If we are unable to attract consumers to our website through these devices or are slow to develop a version of our website that is more compatible with alternative devices, we may fail to capture a significant share of consumers in the market for diamonds and fine jewelry, which could adversely affect our business.

We have foreign exchange risk.

The results of operations of Blue Nile Jewellery, Ltd., our Ireland subsidiary, are exposed to foreign exchange rate fluctuations. Upon translation from foreign currency into U.S. dollars, operating results may differ materially from expectations, and we may record significant gains or losses.

Additionally, we allow customers to purchase our products in 24 foreign currencies. This exposes us to foreign exchange rate fluctuations and we may record significant gains or losses as a result of such fluctuations.

Our net sales may be negatively affected if we are required to collect taxes on purchases.

We collect sales and/or other taxes related to purchases by customers located in the State of Washington and the State of New York, and certain taxes required to be collected on sales to customers outside of the United States. One or more states or foreign countries have sought and others may seek to impose additional sales or other tax collection obligations on us in the future. A successful assertion by one or more states or foreign countries to require the collection of sales or other taxes on the sale of our products could result in substantial tax liabilities for past sales, discourage customers from purchasing products from us, decrease our competitive advantage, cause us to discontinue certain successful sales and marketing initiatives or otherwise substantially harm our business and results of operations.

While we believe that current law restricts state and local taxing authorities outside the State of Washington from requiring us to collect sales and use taxes from purchasers located within their jurisdictions, taxing authorities outside the State of Washington have, and in the future could, disagree with our interpretation. For example, a number of states, as well as the U.S. Congress, are considering or have adopted various initiatives designed to impose sales, use and other taxes on Internet sales. The successful implementation of any such initiatives could require us to collect sales, use and other taxes from purchasers located in states other than Washington. The imposition by state and local governments of various taxes upon Internet commerce could create administrative burdens for us and could significantly decrease our future net sales.

We rely on the services of our small, specialized workforce and key personnel, many of whom would be difficult to replace.

We rely upon the continued service and performance of key technical, fulfillment and senior management personnel. If we lose any of these personnel, our business could suffer. Competition for qualified personnel in our industry is intense. We believe that our future success will depend on our continued ability to attract, hire and retain key employees. Other than for our Executive Chairman, we do not have key person life insurance policies covering any of our employees. In addition, illness, severe adverse weather conditions or natural disasters could impede our ability to service our customers.

We face the risk of theft of our products from inventory or during shipment.

We have experienced and may continue to experience theft of our products while they are being held in our fulfillment centers or during the course of shipment to our customers by third-party shipping carriers. We have taken steps to prevent such theft. However, if security measures fail, losses exceed our insurance coverage or we are not able to maintain insurance at a reasonable cost, we could incur significant losses from theft, which would substantially harm our business and results of operations.

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Our failure to protect confidential information of our customers and our network against security breaches could damage our reputation and brand and substantially harm our business and results of operations.

A significant barrier 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. Currently, a majority of our sales are billed to our customers credit card accounts directly. We rely on encryption and authentication technology licensed from third parties to effect secure transmission of confidential information, including credit card numbers. Advances in computer capabilities, human errors, 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 customer's transaction data. An increasing number of websites and Internet companies have reported breaches of their security. Any such compromise of our security could damage our reputation, business 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, damage our computers or those of our users, or otherwise damage our reputation and business. These issues are likely to become more difficult as we expand the number of countries in which we operate. We may need to expend significant resources to protect against security breaches or to address problems caused by breaches.

Our net sales consist exclusively of diamonds and fine jewelry, and demand for these products could decline.

Our net sales and results of operations are highly dependent on the demand for diamonds and diamond jewelry, particularly engagement rings. Should prevailing consumer tastes for diamonds decline or customs with respect to engagement shift away from the presentation of diamond jewelry, demand for our products would decline and our business and results of operations would be substantially harmed.

The significant cost of diamonds results in part from their scarcity. From time to time, attempts have been made to develop and market synthetic stones and gems to compete in the market for diamonds and diamond jewelry. We expect such efforts to continue in the future. If any such efforts are successful in creating widespread demand for alternative diamond products, demand and price levels for our products would decline and our business and results of operations would be substantially harmed.

In recent years, increased attention has been focused on conflict diamonds, which are diamonds extracted from war-torn regions in Africa and sold by rebel forces to fund insurrection. Diamonds are, in some cases, also believed to be used to fund terrorist activities in some regions. We support the Kimberley Process, an international initiative intended to ensure diamonds are not illegally traded to fund conflict. As part of this initiative, we require our diamond suppliers to sign a statement acknowledging compliance with the Kimberley Process, and invoices received for diamonds purchased by us must include a certification from the vendor that the diamonds are conflict free. In addition, we prohibit the use of our business or services for money laundering or terrorist financing in accordance with the USA Patriot Act. Through these and other efforts, we believe that the suppliers from whom we purchase our diamonds exclude conflict diamonds from their inventories. However, we cannot independently determine whether any diamond we offer was extracted from these regions. Current efforts to increase consumer awareness of this issue and encourage legislative response could adversely affect consumer demand for diamonds. Consumer confidence is dependent, in part, on the certification of our diamonds by independent laboratories. A decline in the quality of the certifications provided by these laboratories could adversely impact demand for our products. Additionally, a decline in consumer confidence in the credibility of independent diamond grading certifications could adversely impact demand for our diamond products.

Our fine jewelry offerings must reflect the tastes and preferences of a wide range of consumers whose preferences may change regularly. Our strategy has been to offer primarily what we consider to be classic styles of fine jewelry, but there can be no assurance that these styles will continue to be popular with

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consumers in the future. If the styles we offer become less popular with consumers and we are not able to adjust our product offerings in a timely manner, our net sales may decline or fail to meet expected levels.

System interruptions that impair customer access to our websites would damage our reputation and brand and substantially harm our business and results of operations.

The satisfactory performance, reliability and availability of our websites, transaction processing systems and network infrastructure are critical to our reputation, our ability to attract and retain customers, and to maintain adequate customer service levels. Any future systems interruptions, downtime or technical difficulties that result in the unavailability of our websites or reduced order fulfillment performance could result in negative publicity, damage our reputation and brand, and cause our business and results of operations to suffer. We may be susceptible to such disruptions in the future. We may also experience temporary system interruptions for a variety of other reasons in the future, including power failures, failures of Internet service and telecommunication providers, software or human errors, or an overwhelming number of visitors trying to reach our websites during periods of strong seasonal demand or promotions. Because we are dependent, in part, on third parties for the implementation and maintenance of certain aspects of our systems and because some of the causes of system interruptions may be outside of our control, we may not be able to remedy such interruptions in a timely manner, or at all.

In order to increase net sales and to sustain or increase profitability, we must attract customers in a cost-effective manner.

Our success depends on our ability to attract customers in a cost-effective manner. We have relationships with providers of online services, search engines, directories and other websites and e-commerce businesses to provide content, advertising banners and other links that direct customers to our websites. We rely on these relationships as significant sources of traffic to our websites. Our agreements with these providers generally have terms of one year or less. If we are unable to develop or maintain these relationships on acceptable terms, our ability to attract new customers would be harmed. In addition, many of the parties with whom we have online-advertising arrangements could provide advertising services to other companies, including retailers with whom we compete. As competition for online advertising has increased, the cost for these services has also increased. A significant increase in the cost of the marketing vehicles upon which we rely could adversely impact our ability to attract customers in a cost-effective manner and harm our business and results of operations.

The success of our business may depend on our ability to successfully expand our product offerings.

Our ability to significantly increase our net sales and maintain and increase our profitability may depend on our ability to successfully expand our product lines beyond our current offerings. If we offer a new product category that is not accepted by consumers, the Blue Nile brand and reputation could be adversely affected, our net sales may fall short of expectations and we may incur substantial expenses that are not offset by increased net sales. Expansion of our product lines may also strain our management and operational resources.

If we are unable to accurately manage our inventory of fine jewelry, our reputation and results of operations could suffer.

Except for loose diamonds, substantially all of the fine jewelry we sell is from our physical inventory. We are faced with the constant challenge of balancing our inventory levels with our ability to meet our customer needs. Based on internally generated projections, we purchase jewelry and jewelry components. These projections are based on many unknown assumptions around consumer demand, time to manufacture, pricing, etc. If these inventory projections are too high, our inventory may be too high, which may result in lower retail prices and gross margins, risk of obsolescence, and harm to our results of operations. Conversely, if these projections are too low, and we

underestimate the consumer demand for a product(s), we are exposed to lost business opportunities which could have a material adverse effect on our business, results of operations, financial condition and cash flows. Additionally, as we increase our offering of products, we may be forced to increase inventory levels, which will increase our risks related to our inventory.

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Our stock price has been volatile historically, and may continue to be volatile. Further, the sale of our common stock by significant stockholders may cause the price of our common stock to decrease.

The trading price of our common stock has been and may continue to be subject to wide fluctuations. Our stock price may fluctuate in response to a number of events and factors, such as quarterly variations in operating results, announcements by us or our competitors, including announcements relating to strategic decisions or key personnel, service disruptions, changes in financial estimates and recommendations by security analysts, the operating and stock price performance of other companies that investors may deem comparable to us, and news reports relating to trends in our markets or general economic conditions. In addition, several of our stockholders own significant portions of our common stock. If these stockholders were to sell all or a portion of their holdings of our common stock, the market price of our common stock could be negatively impacted. The effect of such sales, or of significant portions of our stock being offered or made available for sale, could result in strong downward pressure on our stock price. Investors should be aware that they could experience significant short-term volatility in our stock if such stockholders decide to sell all or a portion of their holdings of our common stock at once or within a short period of time.

Repurchases of our common stock may not prove to be the best use of our cash resources.

We have and plan to continue to opportunistically repurchase shares of our common stock. Since the inception of our share repurchase program in the first quarter of 2005 through January 2, 2011, we have repurchased 4.9 million shares for a total of \$186.5 million. In February 2010, our board of directors authorized the repurchase of up to \$100 million of our common stock during the subsequent 24-month period. These repurchases and any repurchases we may make in the future may not prove to be at optimal prices and our use of cash for the stock repurchase program may not prove to be the best use of our cash resources and may adversely impact our future liquidity.

Our cash, cash equivalents and short-term investments are subject to a risk of loss based upon the solvency of the financial institutions in which they are maintained.

We maintain the majority of our cash, cash equivalents and short-term investments in accounts with major financial institutions within the United States, in the form of demand deposits, money market accounts, time deposits, U.S. Treasury Bills and other short-term investments. Deposits in these institutions may exceed the amounts of insurance provided, or deposits may not at all be covered by insurance. If any of these institutions becomes insolvent, it could substantially harm our financial condition and we may lose some, or all, of such deposits.

Failure to adequately protect or enforce our intellectual property rights 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 afford only limited protection. Despite our efforts to protect and enforce our proprietary rights, unauthorized parties have attempted, and may in the future attempt, to copy aspects of our website features, compilation and functionality or to obtain and use information that we consider as proprietary, such as the technology used to operate our websites, our content and our trademarks. We have registered Blue Nile, bluenile.com, the BN logo, the Blue Nile BN stylized logo and Build Your Own Ring as trademarks in the United States and in certain other countries. Our competitors have, and other competitors may, adopt service names similar to ours, thereby impeding our ability to build brand identity and possibly leading to consumer confusion. In addition, there could be potential trade name or trademark infringement claims brought by owners of other registered trademarks or trademarks that incorporate variations of the term Blue Nile or our other trademarks. Any claims or consumer confusion related to our trademarks could damage our reputation and brand and substantially harm our business and results of operations.

We currently hold the bluenile.com, bluenile.co.uk and bluenile.ca Internet domain names and various other related domain names. Domain names generally are regulated by Internet regulatory bodies. If we lose the ability to use a domain name in a particular country, we would be forced to either incur significant

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additional expenses to market our products within that country, including the development of a new brand and the creation of new promotional materials and packaging, or elect not to sell products in that country. Either result could substantially harm our business and results of operations. The regulation of domain names in the United States and in foreign countries is subject to change. Regulatory bodies could establish additional top-level domains, appoint additional domain name registrars or modify the requirements for holding domain names. As a result, we may not be able to acquire or maintain the domain names that utilize the name Blue Nile in all of the countries in which we currently or intend to conduct business.

Litigation or proceedings before the U.S. Patent and Trademark Office or similar international regulatory agencies may be necessary in the future to enforce our intellectual property rights, to protect our trade secrets and domain names and to determine the validity and scope of the proprietary rights of others. Any litigation or adverse priority proceeding could result in substantial costs and diversion of resources and could substantially harm our business and results of operations. We sell and intend to increasingly sell our products internationally, and the laws of many countries do not protect our proprietary rights to as great an extent as do the laws of the United States.

Assertions by third parties of infringement by us of their intellectual property rights could result in significant costs and substantially harm our business and results of operations.

Third parties have, and may in the future, assert that we have infringed their technology or other intellectual property rights. We cannot predict whether any such assertions or claims arising from such assertions will substantially harm our business and results of operations. If we are forced to defend against any infringement claims, whether they are with or without merit or are determined in our favor, we may face costly litigation, diversion of technical and management personnel, or product shipment delays. Furthermore, the outcome of a dispute may be that we would need to develop non-infringing technology or enter into royalty or licensing agreements. Royalty or licensing agreements, if required, may be unavailable on terms acceptable to us, or at all.

Increased product returns and the failure to accurately predict product returns could substantially harm our business and results of operations.

We generally offer our customers an unconditional 30-day return policy that allows our customers to return most products if they are not satisfied for any reason. We make allowances for product returns in our financial statements based on historical return rates and current economic conditions. Actual merchandise returns are difficult to predict and may differ from our allowances. Any significant increase in merchandise returns above our allowances would substantially harm our business and results of operations.

Purchasers of diamonds and fine jewelry may not choose to shop online, which would prevent us from growing our business.

The online market for diamonds and fine jewelry is significantly less developed than the online market for books, music, toys and 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 consumers who have historically purchased diamonds and fine jewelry through traditional retailers. Furthermore, we may have to incur significantly higher and more sustained advertising and promotional expenditures or price our products more competitively than we currently anticipate in order to attract additional online consumers to our websites and convert them into purchasing customers. Specific factors that could prevent consumers from purchasing diamonds and fine jewelry from us include:

concerns about buying luxury products such as diamonds and fine jewelry without a physical storefront, face-to-face interaction with sales personnel and the ability to physically handle and examine products;

delivery time associated with Internet orders;

product offerings that do not reflect consumer tastes and preferences;

pricing that does not meet consumer expectations;

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concerns about the security of online transactions and the privacy of personal information;

delayed shipments or shipments of incorrect or damaged products;

inconvenience associated with returning or exchanging Internet purchased items; and

usability, functions and features of our websites.

If use of the Internet, particularly with respect to online commerce, does not continue to increase as we anticipate, our business and results of operations will be harmed.

Our future net sales and profits are substantially dependent upon the continued growth in the use of the Internet as an effective medium of business and communication by our target customers. Internet use may not continue to develop at historical rates and consumers may not continue to use the Internet and other online services as a medium for commerce. Failures by some online retailers to meet consumer demands could result in consumer reluctance to adopt the Internet as a means for commerce, and thereby damage our reputation and brand and substantially harm our business and results of operations.

In addition, the Internet may not be accepted as a viable long-term commercial marketplace for a number of reasons, including:

actual or perceived lack of security of information or privacy protection;

possible disruptions, computer viruses, spyware, phishing, attacks or other damage to the Internet servers, service providers, network carriers and Internet companies or to users' computers; and

excessive governmental regulation.

Our success will depend, in large part, upon third parties maintaining the Internet infrastructure to provide a reliable network backbone with the speed, data capacity, security and hardware necessary for reliable Internet access and services. Our business, which relies on a contextually rich website that requires the transmission of substantial secure data, is also significantly dependent upon the availability and adoption of broadband Internet access and other high speed Internet connectivity technologies.

Our failure to address risks associated with payment methods, credit card fraud and other consumer fraud could damage our reputation and brand and may cause our business and results of operations to suffer.

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 face the risk of significant losses from this type of fraud as our net sales increase and as we expand internationally. Our failure to adequately control fraudulent credit card transactions could damage our reputation and brand and substantially harm our business and results of operations. Additionally, for certain payment transactions, including credit and debit cards, we pay interchange and other fees. These fees may increase over time, which would raise our operating costs and lower our operating margins.

We rely on our relationship with a third-party consumer credit company to offer financing for the purchase of our products.

The purchase of the diamond and fine jewelry products we sell is a substantial expense for many of our customers. We currently rely on our relationship with a consumer finance company to provide financing to our customers. If we are unable to maintain this or other similar arrangements, we may not be able to offer financing alternatives to our customers, which may reduce demand for our products and substantially harm our business and results of operations.

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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 websites through internal development. However, from time to time, we may selectively pursue acquisitions of businesses, technologies or services. Integrating any newly acquired businesses, technologies or services may be expensive and time-consuming. To finance any acquisitions, 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. If we do complete any acquisitions, we may be unable to operate such acquired businesses profitably or otherwise implement our strategy successfully. If we are unable to integrate any newly acquired entities or technologies effectively, our business and results of operations could 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. We have no current plans, agreements or commitments with respect to any such acquisitions.

Our failure to rapidly respond to technological change could result in our services or systems becoming obsolete and substantially harm our business and results of operations.

As the Internet and online commerce industries evolve, we may be required to license emerging technologies useful in our business, enhance our existing services, develop new services and technologies that address the increasingly sophisticated and varied needs of our prospective customers and respond to technological advances and emerging industry standards and practices on a cost-effective and timely basis. We may not be able to successfully implement new technologies or adapt our websites, proprietary technologies and transaction-processing systems to customer requirements or emerging industry standards. Our failure to do so would substantially harm our business and results of operations. We may be required to upgrade existing technologies or business applications, or implement new technologies or business applications. Our results of operations may be affected by the timing, effectiveness and costs associated with the successful implementation of any upgrades or changes to our systems and infrastructure.

We may have exposure to greater than anticipated tax liabilities.

We are subject to income, payroll, duties and other business taxes in both the United States and foreign jurisdictions. In the ordinary course of our business, there are many transactions and calculations where the ultimate tax determination is uncertain. Our determination of our tax liability is always subject to review by applicable taxing authorities. Any adverse outcome of such a review could have a negative effect on our operating results and financial condition. Although we believe our estimates are reasonable, the ultimate tax outcome may differ from the amounts recorded in our financial statements and may materially affect our financial results in the period or periods for which such determination is made. In addition, the imposition of additional tax obligations on our business by state and local governments could create significant administrative burdens for us, decrease our future sales, and harm our cash flow and operating results.

Government regulation of the Internet and e-commerce is evolving and unfavorable changes could substantially harm our business and results of operations.

We are not currently subject to direct federal, state or local regulation other than regulations applicable to businesses generally or directly applicable to retailing and online commerce. However, as the Internet becomes increasingly popular, it is possible that laws and regulations may be adopted with respect to the Internet, which may impede the growth of Internet-based businesses. These regulations and laws may cover issues such as taxation, advertising,

intellectual property rights, freedom of expression, pricing, restrictions on imports and exports, customs, tariffs, information security, privacy, data protection, content, distribution, electronic contracts and other communications, the provision of online payment services, broadband residential Internet access, and the characteristics and quality of products and services. Further, the growth of online commerce

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may prompt calls for more stringent consumer protection laws. Several states have proposed legislation to limit the uses of personal user information gathered online or require online companies to establish privacy policies. The Federal Trade Commission has also initiated action against at least one online company regarding the manner in which personal information is collected from users and provided to third parties. The adoption of additional privacy or consumer protection laws could create uncertainty in Internet usage and reduce the demand for our products and services.

We are not certain how our business may be affected by the application of existing laws governing issues such as property ownership, copyrights, personal property, encryption and other intellectual property issues, taxation, libel, obscenity, qualification to do business, and export or import matters. The vast majority of these laws were adopted prior to the advent of the Internet. As a result, they do not contemplate or address the unique issues of the Internet and related technologies. Changes in laws intended to address these issues could create uncertainty for those conducting online commerce. This uncertainty could reduce demand for our products and services or increase the cost of doing business as a result of litigation costs or increased fulfillment costs and may substantially harm our business and results of operations.

We may need to implement additional finance and accounting systems, procedures and controls as we grow our business and organization and to satisfy new reporting requirements.

As a public reporting company, we are required to comply with the Sarbanes-Oxley Act of 2002 and the related rules and regulations of the SEC, including expanded disclosures and accelerated reporting requirements and more complex accounting rules. Compliance with these and other new requirements may increase our costs and require additional management time and resources. We may need to implement additional finance and accounting systems, procedures and controls to satisfy new reporting requirements. If our internal control over financial reporting is determined to be ineffective, investors could lose confidence in the reliability of our internal control over financial reporting, which could adversely affect our stock price.

Our failure to effectively manage the growth in our operations may prevent us from successfully expanding our business.

We have experienced, and in the future may experience, rapid growth in operations, which has placed, and could continue to place, a significant strain on our operations, services, internal controls and other managerial, operational and financial resources. To effectively manage future expansion, we will need to maintain our operational and financial systems and managerial controls and procedures, which include the following processes:

- transaction processing and fulfillment;
- inventory management;
- customer support;
- management of multiple supplier relationships;
- operational, financial and managerial controls;
- reporting procedures;
- management of our facilities;

recruitment, training, supervision, retention and management of our employees; and
technology operations.

If we are unable to manage future expansion, our ability to provide a high quality customer experience could be harmed, which would damage our reputation and brand and substantially harm our business and results of operations.

Table of Contents**Item 1B. *Unresolved Staff Comments***

None.

Item 2. *Properties*

As of January 2, 2011, our operational facilities consisted of three separate locations: a corporate headquarters and fulfillment center located in Seattle, Washington and a fulfillment center located in Dublin, Ireland. Our corporate headquarters consists of approximately 24,000 square feet of office space and is subject to a sub-lease that expires in April 2011. Our U.S. fulfillment center consists of approximately 27,000 square feet of warehouse space and is subject to a lease that expires in October 2011. Our Ireland fulfillment center consists of approximately 10,000 square feet of combined office and warehouse space and is subject to a lease expiring in December 2011. Certain of the leases include renewal provisions at our option. We believe that the facilities housing our fulfillment centers will be adequate to meet our current requirements for our operations and that suitable additional or substitute space will be available as needed. In January 2011, we signed a new lease agreement for office space for our corporate headquarters. The new lease will commence on May 1, 2011. See Note 13 to the consolidated financial statements included in Item 8 of this Report for additional information.

Item 3. *Legal Proceedings*

See discussion of legal proceedings in Note 4 to the consolidated financial statements included in Item 8 of this Report.

Item 4. *(Removed and Reserved)***PART II****Item 5. *Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities*****Market Information and Dividend Policy**

Our Common Stock is quoted on The NASDAQ Stock Market LLC under the symbol NILE. On February 17, 2011 we had approximately 41 stockholders based on the number of record holders.

The following table sets forth the high and low sales prices of our common stock for fiscal years 2010 and 2009. The quotations are as reported in published financial sources.

	High	Low
Fiscal year 2010:		
First Quarter	\$ 64.38	\$ 45.51
Second Quarter	\$ 58.71	\$ 44.91
Third Quarter	\$ 52.25	\$ 40.70
Fourth Quarter	\$ 63.10	\$ 40.86
Fiscal year 2009:		
First Quarter	\$ 36.61	\$ 18.34
Second Quarter	\$ 51.23	\$ 32.03

Third Quarter	\$ 63.00	\$ 36.00
Fourth Quarter	\$ 67.16	\$ 55.03

We have not paid any cash dividends on our common stock since inception, and it is not anticipated that cash dividends will be paid on shares of our common stock in the foreseeable future. Any future determination to pay dividends will be at the discretion of our board of directors.

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Performance Measurement Comparison(1)

The following graph compares the total cumulative stockholder return on the Company's common stock with the total cumulative return of the Nasdaq Market Index and the RDG Internet Composite Index for the five-year period ending on January 2, 2011, our 2010 fiscal year end. Historical stock price performance should not be relied upon as an indication of future stock price performance.

COMPARISON OF 5 YEAR CUMULATIVE TOTAL RETURN(2)

**Among BlueNile, Inc., The NASDAQ Composite Index
and The RDG Internet Composite Index**

- (1) This Section is not soliciting material, is not deemed filed with the SEC and is not to be incorporated by reference in any of our filings under the 1933 Act or the 1934 Act whether made before or after the date hereof and irrespective of any general incorporation language in any such filing.
- (2) Assumes \$100 was invested on January 1, 2006 at the closing price on this day, in Blue Nile's common stock and each index, and all dividends have been reinvested. No cash dividends have been declared on Blue Nile's common stock. Stockholder returns over the indicated period should not be considered indicative of future stockholder returns.

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Item 6. *Selected Consolidated Financial Data*

The table below shows selected consolidated financial data for each of our fiscal years ended January 2, 2011, January 3, 2010, January 4, 2009, December 30, 2007, and December 31, 2006. The consolidated statements of operations data and the additional operating data for each of the fiscal years ended January 2, 2011, January 3, 2010, and January 4, 2009 and the consolidated balance sheets as of January 2, 2011 and January 3, 2010 are derived from our audited consolidated financial statements included elsewhere in this report. The consolidated statements of operations for the fiscal years ended December 30, 2007 and December 31, 2006 and the consolidated balance sheet data as of January 4, 2009, December 30, 2007 and December 31, 2006, are derived from audited consolidated financial statements not included in this report.

You should read the following selected consolidated financial and operating information together with Management's Discussion and Analysis of Financial Condition and Results of Operations and our audited consolidated financial statements and the related notes included elsewhere in this Annual Report on Form 10-K. The historical results presented below are not necessarily indicative of future results. See Note 10 of the related notes to our consolidated financial statements included in Item 8 of this Report for the calculation of weighted average shares outstanding used in computing basic and diluted net income per share.

Table of Contents**BLUE NILE, INC.****SELECTED CONSOLIDATED FINANCIAL DATA**

	Year Ended January 2, 2011	Year Ended January 3, 2010	Year Ended January 4, 2009(2)	Year Ended December 30, 2007	Year Ended December 31, 2006
(In thousands, except per share data)					
Consolidated Statements of Operations Data:					
Net sales	\$ 332,889	\$ 302,134	\$ 295,329	\$ 319,264	\$ 251,587
Gross profit	71,940	65,344	59,996	65,204	50,853
Selling, general and administrative expenses	50,654	45,997	44,005	42,792	34,296
Operating income	21,286	19,347	15,991	22,412	16,557
Income before income taxes	21,538	19,678	17,856	26,587	19,980
Income tax expense	7,396	6,878	6,226	9,128	6,916
Net income	\$ 14,142	\$ 12,800	\$ 11,630	\$ 17,459	\$ 13,064
Basic net income per share	\$ 0.98	\$ 0.88	\$ 0.78	\$ 1.10	\$ 0.79
Diluted net income per share	\$ 0.94	\$ 0.84	\$ 0.75	\$ 1.04	\$ 0.76
Shares used in computing basic net income per share	14,446	14,534	14,925	15,919	16,563
Shares used in computing diluted net income per share	15,080	15,216	15,505	16,814	17,278
Additional Operating Data:					
Net cash provided by (used in) operating activities	\$ 41,608	\$ 39,018	\$ (2,927)	\$ 41,455	\$ 40,518
Gross profit margin	21.6%	21.6%	20.3%	20.4%	20.2%
Selling, general and administrative expenses as a percentage of net sales	15.2%	15.2%	14.9%	13.4%	13.6%

	As of January 2, 2011	As of January 3, 2010	As of January 4, 2009(2)	As of December 30, 2007	As of December 31, 2006
(In thousands)					

Consolidated Balance Sheet Data:

Cash and cash equivalents	\$ 113,261	\$ 78,149	\$ 54,451	\$ 122,793	\$ 78,540
Marketable securities					19,767
Short-term investments		15,000			
Accounts receivable	1,771	1,835	1,709	3,576	1,640

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Inventories	20,166	19,434	18,834	20,906	14,616
Accounts payable	90,296	76,128	62,291	85,866	66,625
Working capital(1)	34,918	29,662	7,589	53,455	41,881
Total assets	151,811	130,415	89,665	160,586	122,106
Total long-term obligations	830	964	1,213	1,418	666
Total stockholders equity	49,061	43,269	19,308	63,477	47,303

(1) Working capital consists of total current assets, including cash, cash equivalents and short-term investments, less total current liabilities.

(2) Fiscal year 2008 consists of 53 weeks, which is one week longer than the other fiscal years presented.

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Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion should be read in conjunction with the consolidated financial statements and related notes which appear elsewhere in this report. This discussion contains forward-looking statements that involve risks and uncertainties. Our actual results could differ materially from those anticipated in these forward-looking statements as a result of various factors, including those discussed below and elsewhere in this report, particularly under the heading Item 1A. Risk Factors.

Management Overview

Our long-term financial focus is primarily on sustainable growth in free cash flow¹ Non-GAAP free cash flow is primarily driven by increasing our operating income and efficiently managing working capital and capital expenditures. Increases in operating income primarily result from increases in sales through our websites, improvements in operating margins and the efficient management of operating costs, offset by the investments that we make in longer-term strategic initiatives.

Commitment to Customer Service

Our focus is on delivering an unparalleled customer experience. We design our websites to offer easy to understand, step-by-step guides to visualizing, evaluating, selecting and purchasing diamonds and fine jewelry. We continue to refine the customer service experience in every step of the purchase process from our websites to our customer support, product quality and fulfillment operations. Our customer support centers are staffed with non-commissioned diamond and jewelry consultants who offer advice and guidance to customers via phone, chat or email. Our diamond and jewelry consultants are subject to ongoing training and carry expertise about diamonds and fine jewelry. We continue to invest in optimizing our fulfillment operations to ensure that our customized products can be delivered as soon as one business day, but generally within three business days of order.

Customer feedback and customer satisfaction ratings are among the key non-financial measures we review. We believe that maintaining high overall customer satisfaction is critical to customer referrals and our ongoing efforts to elevate the Blue Nile brand and to increase our net sales and net income. We actively solicit customer feedback on our website functionality as well as on the entire purchase experience.

Differentiating Factors and Value Proposition

We have built an innovative business model designed to deliver exceptional value and service to customers. We have developed relationships with a large number of diamond suppliers with whom we have exclusive agreements as an online retailer. Our unique inventory model allows us to offer our customers access to a large selection of high quality diamonds. In most cases, we purchase diamonds from our suppliers only as our customers place orders from us. As a result, we do not incur the significant costs that would be incurred by physical retail stores to carry high levels of diamond inventory. Our efficient operating model also provides for negative working capital benefits, since payments are received from customers within a few days of shipment of their order, but our vendor payment terms are typically in the 45-120 day range.

As an online retailer, we also do not incur most of the operating costs associated with physical retail stores, including occupancy costs and related overhead. As a result, while our gross profit margins are lower than those typically maintained by traditional diamond and fine jewelry retailers, we are able to realize relatively higher operating income as a percentage of net sales. In the year ended January 2, 2011, we had a 21.6% gross profit margin, as compared to what we believe to be gross profit margins of up to 50% or more by some traditional jewelry retailers. Our lower gross

profit margins result from lower retail prices that we offer to our customers. We believe that these lower prices, in turn, will result in increasing our market share in the luxury jewelry retail space.

¹ Blue Nile defines free cash flow, a non-GAAP financial measure, as net cash provided by (used in) operating activities less cash outflows for purchases of fixed assets, including internal use software and website development.

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Focus on Growth

A customer's first purchase from Blue Nile is often an engagement ring. Our goal is to provide an unrivaled customer experience such that we become our customers' jeweler for life. We have continued to expand our product lines to include non-engagement diamond jewelry as well as other products such as pearls, gemstones and various silver, gold and platinum offerings and watches. Expansion of our product lines has allowed us to broaden our reach with a wider range of price points and merchandise offerings, attracting new customers to our brand. Our satisfied customers are an important source of referrals that we believe will further drive growth.

During 2010, we launched a mobile website designed for iPhone, iPod touch and Android mobile device users. We also launched a free diamond shopping application for iPhone and iPod Touch. The iPhone app and mobile website allow consumers to browse our educational materials, search for diamonds and jewelry, connect to our diamond and jewelry consultants and make a purchase through their mobile device. We believe this blend of convenience and real-time, transparent and in-depth information enhances our customer experience. Further, we increased our marketing and public relations efforts via social media such as Facebook, to create a unique customer experience to celebrate the holidays and to enhance customer awareness. We plan to continue to pursue these opportunities and offerings to expand brand awareness and increase our market share.

We intend to selectively pursue opportunities in international markets in which we can leverage our existing infrastructure and value proposition. In 2010, our international sales grew 30.4% compared to 2009 and represented 13% of our sales for the year. International growth is a priority and we will continue to pursue international growth opportunities based on a number of factors, including, but not limited to, each market's consumer spending on diamonds and jewelry, adoption rate of online purchasing and overall competitive landscape.

Trends

Throughout 2010, the macroeconomic conditions affected our business. Although U.S. consumer confidence improved in the fourth quarter, high levels of unemployment, unpredictable consumer behavior, economic volatility abroad and various other factors affected consumer spending in 2010. These conditions continue to have an impact on consumer spending, including the sale of luxury products such as diamonds and fine jewelry. Our low-cost business model provides us the flexibility to operate profitably throughout the difficult consumer environment while the industry as a whole has struggled. We believe that our broad selection, focus on exceptional service and the value that we offer resonated with consumers, as demonstrated by our sales and earnings growth in fiscal year 2010.

Critical Accounting Policies

The preparation of our consolidated financial statements requires that we make certain estimates and judgments that affect amounts reported and disclosed in our consolidated financial statements and related notes. We base our estimates on historical experience and on other assumptions that we believe to be reasonable under the circumstances. Actual results may differ from these estimates. The following are the critical accounting policies that we believe require significant estimation and management judgment.

Revenue Recognition

We recognize revenue and the related gross profit on the date on which ownership passes from Blue Nile to our customers. For customers in the U.S., Canada and the E.U., ownership passes at the time the package is received by the customer. For customers in other locations, ownership passes at the time the product is shipped. As we require customer payment prior to order shipment, any payments received prior to the transfer of ownership are not recorded as revenue. For U.S., Canadian and E.U. shipments, we utilize our freight vendors' tracking information to determine

when delivery has occurred, which is typically within one to three days after shipment. We reduce revenue by a provision for returns, which is estimated based on our historical

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product return rates and current economic conditions. Our contracts with our suppliers generally allow us to return diamonds purchased and returned by our customers.

Stock-based Compensation

We account for stock-based compensation at fair value. We use the Black-Scholes-Merton option valuation model, which requires the input of highly subjective assumptions. These assumptions include estimating the length of time employees will retain their vested stock options before exercising them (expected term) and the estimated volatility of our common stock price over the expected term (expected volatility). Changes in these assumptions can materially affect the estimate of the fair value of employee stock options and consequently, the related amount of stock-based compensation expense recognized in the consolidated statements of operations.

We performed the following sensitivity analysis using changes in the expected term and expected volatility that could be reasonably possible in the near term. If we assumed a six-month increase or decrease in the expected term or a 500 basis point increase or decrease in expected volatility, the value of a newly granted hypothetical stock option would increase (decrease) by the following percentages:

	Increase	Decrease
Expected term(1)	5.4%	(5.9)%
Expected volatility(1)	7.2%	(7.4)%

- (1) Sensitivity to change in assumptions was determined using the Black-Scholes-Merton valuation model compared to the following original assumptions: stock price and exercise price equal to the closing market price of Blue Nile, Inc. common stock on December 31, 2010, expected term of 4.0 years, expected volatility of 57.93%, expected dividend yield of 0.0% and a risk-free interest rate of 1.22%.

In addition, we estimate the expected forfeiture rate and only recognize stock-based compensation expense for grants that are expected to vest. We estimate the forfeiture rate based on historical experience. To the extent our actual forfeiture rate is different from our estimate, stock-based compensation expense is adjusted accordingly.

Results of Operations

The following table presents our historical operating results for the periods indicated as a percentage of net sales:

	Year Ended January 2, 2011	Year Ended January 3, 2010	Year Ended January 4, 2009
Net sales	100.0%	100.0%	100.0%
Gross profit	21.6	21.6	20.3
Selling, general and administrative expenses	15.2	15.2	14.9
Operating income	6.4	6.4	5.4

Other income, net	0.1	0.1	0.6
Income before income taxes	6.5	6.5	6.0
Income tax expense	2.3	2.3	2.1
Net income	4.2%	4.2%	3.9%

The following describes certain items set forth in our consolidated statements of operations:

Net Sales. Substantially all of our net sales consist of diamonds and fine jewelry sold via the Internet, net of estimated returns. Historically, net sales have been higher in the fourth quarter as a result of higher

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consumer spending during the holiday season. We expect this seasonal trend to continue in the foreseeable future.

Gross Profit. Our gross profit consists of net sales less the cost of sales. Our cost of sales includes the cost of merchandise sold to customers, inbound and outbound shipping costs, depreciation on assembly-related assets, insurance on shipments and the costs incurred to set diamonds into ring, earring and pendant settings, including labor and related facilities costs. Our gross profit has fluctuated historically and we expect it to continue to fluctuate based primarily on our product acquisition costs, product mix and pricing decisions.

Selling, General and Administrative Expenses. Our selling, general and administrative expenses consist primarily of payroll and related benefit costs for our employees, stock-based compensation, marketing costs and credit card fees. These expenses also include certain facility-related costs, and fulfillment, customer service, technology and depreciation expenses, as well as professional fees and other general corporate expenses.

Fiscal Year. Our fiscal year generally ends on the Sunday closest to December 31. Each fiscal year consists of four 13-week quarters, with one extra week added in the fourth quarter every five to six years. Our fiscal year 2008 included one extra week in the fourth quarter, or 53 weeks for the fiscal year, as a result of our 4-4-5 retail reporting calendar.

The following table presents our historical operating results, including a comparison of the financial results for the periods indicated (dollars in thousands, except per share data):

	Year Ended January 2, 2011	Year Ended January 3, 2010	Year Ended January 4, 2009(1)	Comparison of Year Ended January 2, 2011 to		Comparison of Year Ended January 3, 2010 to	
				Year Ended January 3, 2010		Year Ended January 4, 2009	
				\$ Change	% Change	\$ Change	% Change
Net sales	\$ 332,889	\$ 302,134	\$ 295,329	\$ 30,755	10.2%	\$ 6,805	2.3%
Cost of sales	260,949	236,790	235,333	24,159	10.2%	1,457	0.6%
Gross profit	71,940	65,344	59,996	6,596	10.1%	5,348	8.9%
Selling, general and administrative expenses	50,654	45,997	44,005	4,657	10.1%	1,992	4.5%
Operating income	21,286	19,347	15,991	1,939	10.0%	3,356	21.0%
Other income, net:							
Interest income, net	35	122	1,420	(87)	(71.3)%	(1,298)	(91.4)%
Other income, net	217	209	445	8	3.8%	(236)	(53.0)%
	252	331	1,865	(79)	(23.9)%	(1,534)	(82.3)%
Income before income taxes	21,538	19,678	17,856	1,860	9.5%	1,822	10.2%

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Income tax expense	7,396	6,878	6,226	518	7.5%	652	10.5%
Net income	\$ 14,142	\$ 12,800	\$ 11,630	\$ 1,342	10.5%	\$ 1,170	10.1%
Basic net income per share	\$ 0.98	\$ 0.88	\$ 0.78	\$ 0.10	11.4%	\$ 0.10	12.8%
Diluted net income per share	\$ 0.94	\$ 0.84	\$ 0.75	\$ 0.10	11.9%	\$ 0.09	12.0%

(1) Fiscal year 2008 consists of 53 weeks, which is one week longer than the other fiscal years presented

Comparison of Year Ended January 2, 2011 to Year Ended January 3, 2010

Net Sales

Net sales increased 10.2% in the year ended January 2, 2011, compared with the year ended January 3, 2010, due to an increase in average shipment value, and to a lesser extent, an increase in the number of orders

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shipped to customers. Sales of our non-engagement jewelry grew at a rate above our overall sales growth rate. Year over year sales trends started strong in the first quarter but slowed down considerably in the third quarter as U.S. consumers pulled back on spending over concerns about high unemployment rates, limited access to credit and other macroeconomic factors. U.S. consumer confidence improved in the fourth quarter and combined with our increased marketing and public relations efforts, and expanded product offerings during the holiday season, sales grew to \$114.8 million in the fourth quarter, a record high for any quarter in the Company's history.

Net sales in the U.S. increased by 7.7% to \$289.6 million in 2010 compared with \$268.9 million in the prior year. International sales increased 30.4% to \$43.3 million for the year ended January 2, 2011, compared to \$33.2 million for the year ended January 3, 2010. Increased marketing efforts and expanded brand awareness contributed to the increase in U.S. and international sales. The strength of foreign currencies against the U.S. dollar also contributed to international sales growth. Internally, we monitor our international sales performance on a non-GAAP basis which eliminates the positive or negative effects that result from translating international sales into U.S. dollars (constant exchange rate basis). International sales growth was positively impacted approximately 7.2% due to changes in foreign exchange rates in 2010 compared to the rates in effect during 2009. Excluding the impact of changes in foreign exchange rates, international sales increased 23.2% in the year ended January 2, 2011.

Gross Profit

Gross profit increased \$6.6 million or 10.1% in the year ended January 2, 2011 compared to the year ended January 3, 2010. The increase in gross profit is primarily due to the increase in net sales. Gross profit as a percentage of net sales was equivalent to the prior year at 21.6% in the year ended January 2, 2011 compared to 21.6% in the year ended January 3, 2010.

Costs for our jewelry products are impacted by prices for diamonds and precious metals, including gold, platinum and silver, which rise and fall based upon global supply and demand dynamics. In making retail pricing decisions, we take into account fluctuations in the pricing of diamonds and precious metals, which in turn, affect the gross margin that we realize from such products. While prices for diamonds and precious metals will continue to fluctuate based upon global supply and demand dynamics, we cannot adequately predict the amount and timing of any such fluctuations. We expect that gross profit will fluctuate in the future based on changes in product acquisition costs, particularly diamond prices, product mix and pricing decisions.

Selling, General and Administrative Expenses

Selling, general and administrative expenses increased 10.1% to \$50.7 million in the year ended January 2, 2011 compared to \$46.0 million in the year ended January 3, 2010 due to several factors. Marketing and advertising costs increased \$2.8 million, primarily due to increased investment in online marketing and public relations to drive brand awareness and traffic in support of our growth initiatives. Compensation and related expenses increased \$0.7 million due to increased headcount in support of key business initiatives and growth in sales volumes, partially offset by lower year-over-year incentive accruals. Credit card interchange and payment processing fees increased \$0.7 million based upon higher sales volume. Depreciation expense related to additional capitalized assets added approximately \$0.5 million to expenses. As a percentage of net sales, selling, general and administrative expenses were 15.2% for each of the years ended January 3, 2011 and January 3, 2010.

Other Income, Net

The decrease in interest income for the year ended January 2, 2011 as compared with the year ended January 3, 2010 was due to lower interest rates, partially offset by higher overall cash balances.

Income Taxes

The effective income tax rate for the year ended January 2, 2011 was 34.3% due to lower taxable income in fiscal year 2010 as compared to 35.0% for the year ended January 3, 2010.

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Comparison of Year Ended January 3, 2010 to Year Ended January 4, 2009

Net Sales

Net sales increased 2.3% in the year ended January 3, 2010, compared with the year ended January 4, 2009. Excluding the additional week of sales included in 2008, net sales would have increased 3.3% in 2009 when compared to the prior year. The increase in net sales was due to an increase in the average retail value per order shipped, partially offset by a decrease in the number of orders shipped to customers. Year over year sales trends improved each quarter of the year culminating with strong performance in the fourth quarter of 2009, which had 20.0% sales growth. Net sales in the U.S. increased by 0.5% to \$268.9 million in 2009 compared with \$267.6 million in the prior year. International sales increased 19.9% to \$33.2 million for the year ended January 3, 2010, compared to \$27.7 million for the year ended January 4, 2009.

Our core bridal jewelry category experienced sales trends consistent with the overall business. Sales of our non-engagement jewelry, which is more discretionary, were more impacted by the pullback in consumer spending and were weak in the first half of 2009. Our non-engagement jewelry sales began to improve in the third quarter and strengthened considerably in the fourth quarter holiday season.

International sales contributed significantly to the overall increase in net sales in 2009, representing 1.9% of the 2.3% sales growth. In 2009, we enhanced our websites, expanding our customers' ability to shop and transact in 22 additional foreign currencies. We believe this expansion, increased marketing efforts and expanded brand awareness contributed to the increase in our international sales in 2009 compared to 2008. International sales growth was negatively impacted approximately 7.5% due to changes in foreign exchange rates in 2009 compared to the rates in effect during 2008. Excluding the impact of changes in foreign exchange rates, international sales increased 27.4% in the year ended January 3, 2010.

Gross Profit

Gross profit increased \$5.3 million or 8.9% in the year ended January 3, 2010 compared to the year ended January 4, 2009, primarily due to the \$6.8 million increase in net sales. Gross profit as a percentage of net sales increased by 130 basis points to 21.6% in the year ended January 3, 2010 compared to 20.3% in the year ended January 4, 2009. The increase in gross profit as a percentage of sales is attributable to the continued emphasis on cost optimization related to product sourcing and product sales mix.

Selling, General and Administrative Expenses

Selling, general and administrative expenses increased 4.5% to \$46.0 million in the year ended January 3, 2010 compared to \$44.0 million in the year ended January 3, 2009 due to several factors. Incentive compensation was approximately \$1.3 million compared to zero in the prior year. A \$0.4 million increase in payroll and related expenses was attributable to technology projects in support of business growth and key initiatives, as well as general staffing levels. Depreciation expense related to additional capitalized assets added approximately \$0.5 million to expenses. Credit card processing fees increased \$0.3 million due to higher sales volumes. Stock-based compensation expense increased approximately \$0.2 million primarily due to lower expenses in the prior year related to forfeited options of former employees. These increases were offset by a \$0.6 million decrease in marketing and advertising costs primarily related to decreased spending in online marketing vehicles and a \$0.6 million decrease in legal expenses due to lower spending on intellectual property and other corporate matters. As a percentage of net sales, selling, general and administrative expenses were 15.2% and 14.9% for the years ended January 3, 2010 and January 4, 2009, respectively.

Other Income, Net

The decrease in interest income for the year ended January 3, 2010 as compared with the year ended January 4, 2009 was due to lower interest rates.

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Income Taxes

The effective income tax rate for the year ended January 3, 2010 was 35.0% as compared to 34.9% for the year ended January 4, 2009.

Liquidity and Capital Resources

We are primarily funded by our cash flows from operations. The significant components of our working capital are inventory and liquid assets such as cash and trade accounts receivable, reduced by accounts payable and accrued expenses. Our business model provides certain beneficial working capital characteristics. While we collect cash from sales to customers within several business days of the related sale, we typically have extended payment terms with our suppliers.

Our liquidity is primarily dependent upon our net cash from operating activities. Our net cash from operating activities is sensitive to many factors, including changes in working capital. Working capital at any specific point in time is dependent upon many variables, including our operating results, seasonality, inventory management and assortment expansion, the timing of cash receipts and payments, and vendor payment terms.

As of January 2, 2011, working capital totaled \$34.9 million, consisting of cash and cash equivalents of \$113.3 million, inventory of \$20.2 million and other current assets totaling approximately \$3.3 million, offset by accounts payable of \$90.3 million and other current liabilities totaling approximately \$11.6 million. Due to the seasonal nature of our business, cash and cash equivalents, inventory and accounts payable are generally higher in the fourth quarter, resulting in fluctuations in our working capital.

Net cash provided by operating activities was \$41.6 million in the year ended January 2, 2011 compared to net cash provided by operating activities of \$39.0 million in the year ended January 3, 2010 and net cash used in operating activities of \$2.9 million in the year ended January 4, 2009. The increase in cash provided by operating activities in the year ended January 2, 2011 was primarily attributable to higher net income and the tax benefits realized upon the exercise of stock options. The tax benefit realized from options exercises, which represent the tax deductions in excess of stock compensation expense recorded in the financial statements, increased to \$4.6 million in the year ended January 2, 2011, from \$1.8 million in the year ended January 3, 2010 due to the number of options exercised and the market price of our common stock. The increase in cash was also due to the working capital dynamics of our model associated with the increase in sales in the fourth quarter and the resulting build up in accounts payable. Accounts payable increased by \$14.2 million in the year ended January 2, 2011 compared to an increase of \$13.8 million in the year ended January 3, 2010. We experience greater cash flow from operations in our fourth quarter compared to other quarters due to the significant increase in revenue from our holiday sales. In the first quarter we typically have a significant pay down of our accounts payable balance that was accumulated during the fourth quarter holiday season. These increases were partially offset by a lower cash benefit provided by changes in accrued liabilities. Accrued liabilities increased by \$1.7 million in the year ended January 2, 2011 compared to a net increase of \$3.2 million in the year ended January 3, 2010.

The increase in cash provided by operating activities in the year ended January 3, 2010 compared to the year ended January 4, 2009 was primarily attributable to the increase in accounts payable of \$13.8 million in the year ended January 3, 2010 compared to a decrease of \$23.6 million in the year ended January 4, 2009. Similarly, accrued liabilities increased \$3.2 million at January 3, 2010 compared to a net decrease of \$3.0 million in the year ended January 4, 2009. Tax benefits realized upon the exercise of stock options increased to \$1.8 million in the year ended January 3, 2010, from \$0.5 million in the year ended January 4, 2009 due to the number of options exercised and the market price of our common stock. These increases were partially offset by a decrease in working capital from inventory of \$0.6 million for the year ended January 3, 2010 compared to a net increase in working capital from

inventory of \$2.1 million for the year ended January 4, 2009.

Net cash of \$13.2 million was provided by investing activities in the year ended January 2, 2011, due to the maturity of \$15.0 million in short-term investments, partially offset by purchases of \$1.8 million in property and equipment. Net cash of \$17.3 million was used in investing activities in the year ended January 3,

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2010 due to the purchase of \$15.0 million in short-term investments and \$2.3 million of property and equipment. Net cash used in investing activities of \$2.0 million for the year ended January 4, 2009 was due to the net purchase of property and equipment.

Our capital needs are generally minimal and include investments in technology and websites enhancements, capital improvements to our leased warehouse and office facilities, and furniture and equipment. Additionally, we have the ability to reduce and/or delay capital investments in challenging economic conditions without significant disruption to our business or operations. Over the next 12 months, we expect to purchase property and equipment in connection with our new corporate office space resulting in higher capital expenditures in 2011 compared to 2010.

Net cash used by financing activities in the year ended January 2, 2011 was \$19.6 million, primarily related to the repurchases of common stock. This was partially offset by proceeds from stock option exercises of \$5.4 million. During the year ended January 2, 2011 we repurchased 0.5 million shares of our common stock for an aggregate purchase price of approximately \$25.3 million. Since the inception of our buyback programs in the first quarter of 2005 through January 2, 2011, we have repurchased 4.9 million shares for a total of \$186.5 million. Shares may be repurchased from time to time in open market transactions or in negotiated transactions off the market. The timing and amount of any shares repurchased are determined by management based on our evaluation of market conditions and other factors. Repurchases may also be made under a Rule 10b5-1 plan. We continually assess market conditions, our cash position, operating results, current forecasts and other factors when making decisions about stock repurchases.

Net cash provided by financing activities in the year ended January 3, 2010 was \$2.0 million, primarily related to the proceeds from stock option exercises. Net cash used in financing activities in the year ended January 4, 2009 was \$63.4 million, related to the repurchase of our common stock and partially offset by proceeds from stock option exercises.

The following table summarizes our contractual obligations and the expected effect on liquidity and cash flows as of January 2, 2011 (in thousands).

Contractual Obligations	Total	Less Than 1 Year	1-3 Years	3-5 Years	Over 5 Years
Operating leases(1)	\$ 792	\$ 299	\$ 360	\$ 133	\$
Financing obligation	251	61	136	54	
Purchase obligations(2)	9,661	9,661			
Purchase obligations(3)	115	105	10		
	\$ 10,819	\$ 10,126	\$ 506	\$ 187	\$

(1) On January 6, 2011, we entered a lease agreement for our new corporate headquarters, which we plan to occupy on May 2011 upon the expiration of our current lease. Future rental obligations for the new office lease are not included in the table and are as follows (in thousands): \$279 (less than 1 year), \$1,389 (1-3 years), \$1,475 (3-5 years) and \$4,630 (over 5 years).

(2) Includes open merchandise purchase orders at January 2, 2011.

(3) Includes commitments for advertising and marketing and other services at January 2, 2011.

We believe that our current cash and cash equivalent balances will be sufficient to meet our anticipated operating and capital expenditure needs for at least the next 12 months. We do not carry any long or short-term debt. However, projections of future cash needs and cash flows are subject to many factors and to uncertainty. We continually assess our capital structure and opportunities to obtain credit facilities, sell equity or debt securities, or undertake other transactions for strategic reasons or to further strengthen our financial position. However, there can be no assurance that additional equity, debt or other financing transactions will be available in amounts or on terms acceptable to us, if at all.

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Off-Balance Sheet Arrangements

At January 2, 2011, we did not have any off-balance sheet arrangements or relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purposes entities, which are typically established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes.

Impact of Inflation

The effect of inflation and changing prices on our operations was not significant during the periods presented.

Item 7A. *Quantitative and Qualitative Disclosures About Market Risk*

Foreign Currency Exchange Risk

The majority of our revenue, expense and capital expenditures are transacted in U.S. dollars. Our customers' ability to purchase our products in 24 foreign currencies exposes us to foreign currency exchange risk from the transaction date to when the cash is ultimately converted to U.S. dollars. Because the majority of foreign currency transactions are through third party credit cards that settle within three to four business days, the impact of foreign currency exchange was not material to our results of operations for the fiscal years ended January 2, 2011 and January 3, 2010.

The functional currency of Jewellery, our Irish subsidiary is the Euro. Assets and liabilities of Jewellery are translated into U.S. dollars at the exchange rate prevailing at the end of the period. Income and expenses are translated into U.S. dollars at an average exchange rate during the period. Foreign currency gains and losses from the translation of Jewellery's balance sheet and income statement at January 2, 2011 was a net translation loss of \$0.1 million that was recognized in other comprehensive income.

Interest Rate Risk

We are exposed to financial market risk that results primarily from fluctuations in interest rates. We maintain the majority of our cash, cash equivalents and short-term investments in accounts with major financial institutions within and outside the United States, in the form of demand deposits, money market accounts and other short-term investments. Deposits in these institutions may exceed the amounts of insurance provided, or deposits may not at all be covered by insurance. To date, we have not experienced any losses on our deposits of cash, cash equivalents and short-term investments.

The primary objective of our investment activities is to preserve principal while at the same time maximizing yields without significantly increasing risk. To achieve this objective, we invest in short-term, high quality, interest bearing securities. To minimize our exposure to an adverse shift in interest rates, we invest in short-term securities and maintain an average maturity of one year or less. If interest rates had averaged 100 basis points higher than they did in the year ended January 2, 2011, interest income for the year would have increased approximately 1,145.5%, or \$0.6 million. If interest rates had averaged 100 basis points higher than they did in the year ended January 3, 2010, interest income for the year would have increased approximately 319%, or \$0.5 million.

Item 8. *Financial Statements and Supplementary Data*

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<u>Consolidated Statements of Operations, for the fiscal years ended January 2, 2011, January 3, 2010 and January 4, 2009</u>	38
<u>Consolidated Statements of Changes in Stockholders' Equity, for the fiscal years ended January 2, 2011, January 3, 2010 and January 4, 2009</u>	39
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Financial Statement Schedule	
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All other schedules are omitted because they are not applicable or the required information is shown in the financial statements or notes thereto.	

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of
Blue Nile, Inc.
Seattle, Washington

We have audited the accompanying consolidated balance sheets of Blue Nile, Inc., and subsidiaries (the Company) as of January 2, 2011 and January 3, 2010, and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the three fiscal years in the period ended January 2, 2011. Our audits also included the financial statement schedule listed in the Index at Item 15. These consolidated financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on the consolidated financial statements and financial statement schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the consolidated financial position of the Company as of January 2, 2011 and January 3, 2010, and the results of its operations and its cash flows for each of the three fiscal years in the period ended January 2, 2011, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company's internal control over financial reporting as of January 2, 2011, based on the criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 28, 2011, expressed an unqualified opinion on the Company's internal control over financial reporting.

/s/ Deloitte & Touche LLP

Seattle, Washington
February 28, 2011

Table of Contents**BLUE NILE, INC.****Consolidated Balance Sheets
(In thousands, except par value)**

	January 2, 2011	January 3, 2010
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 113,261	\$ 78,149
Short-term investments		15,000
Trade accounts receivable	1,405	1,594
Other accounts receivable	366	241
Inventories	20,166	19,434
Deferred income taxes	557	449
Prepays and other current assets	1,083	977
Total current assets	136,838	115,844
Property and equipment, net	6,157	7,332
Intangible assets, net	274	325
Deferred income taxes	8,424	6,769
Other assets	118	145
Total assets	\$ 151,811	\$ 130,415
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	\$ 90,296	\$ 76,128
Accrued liabilities	11,490	9,805
Current portion of long-term financing obligation	48	44
Current portion of deferred rent	86	205
Total current liabilities	101,920	86,182
Long-term financing obligation, less current portion	748	796
Deferred rent, less current portion	82	168
Stockholders' equity:		
Preferred stock, \$0.001 par value; 5,000 shares authorized, none issued and outstanding		
Common stock, \$0.001 par value; 300,000 shares authorized; 20,212 shares and 19,810 shares issued, respectively; 14,539 shares and 14,644 shares outstanding, respectively	20	20
Additional paid-in capital	173,143	156,030
Accumulated other comprehensive (loss) income	(66)	61
Retained earnings	63,141	48,999
Treasury stock, at cost; 5,673 shares and 5,166 shares outstanding, respectively	(187,177)	(161,841)

Total stockholders' equity	49,061	43,269
Total liabilities and stockholders' equity	\$ 151,811	\$ 130,415

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

Table of Contents**BLUE NILE, INC.****Consolidated Statements of Operations**
(In thousands, except per share data)

	Year Ended January 2, 2011	Year Ended January 3, 2010	Year Ended January 4, 2009
Net sales	\$ 332,889	\$ 302,134	\$ 295,329
Cost of sales	260,949	236,790	235,333
Gross profit	71,940	65,344	59,996
Selling, general and administrative expenses	50,654	45,997	44,005
Operating income	21,286	19,347	15,991
Other income, net:			
Interest income, net	35	122	1,420
Other income, net	217	209	445
Total other income, net	252	331	1,865
Income before income taxes	21,538	19,678	17,856
Income tax expense	7,396	6,878	6,226
Net income	\$ 14,142	\$ 12,800	\$ 11,630
Basic net income per share	\$ 0.98	\$ 0.88	\$ 0.78
Diluted net income per share	\$ 0.94	\$ 0.84	\$ 0.75

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

Table of Contents**BLUE NILE, INC.****Consolidated Statements of Changes in Stockholders' Equity**
(In thousands)

	Common Stock		Additional	Deferred	Retained	Accumulated	Treasury Stock		Total
	Shares	Amount	Paid-in	Stock	Earnings	Other	Shares	Amount	Stockholders' Equity
Balance, December 30, 2007	19,513	\$ 20	\$ 134,207	\$ (3)	\$ 24,569	\$ 75	(3,540)	\$ (95,391)	\$ 63,477
Net income					11,630				11,630
Other comprehensive income (loss):									
Foreign currency translation adjustment						(58)			(58)
Total comprehensive income									11,572
Tax benefit from exercise of stock options			510						510
Amortization of deferred stock compensation				3					3
Exercise of common stock options	142		2,989						2,989
Issuance of common stock to directors	4		130						130
Stock-based compensation			7,077						7,077
Repurchase of common stock							(1,626)	(66,450)	(66,450)
Balance, January 4, 2009	19,659	20	144,913		36,199	17	(5,166)	(161,841)	19,308
Net income					12,800				12,800
Other comprehensive income (loss):									
Foreign currency translation adjustment						44			44
Total comprehensive income									12,844
Tax benefit from exercise of stock options			1,793						1,793
Exercise of common stock options	147		1,903						1,903
	4		160						160

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Issuance of common stock to directors									
Stock-based compensation			7,261						7,261
Balance, January 3, 2010	19,810	20	156,030	48,999	61	(5,166)	(161,841)		43,269
Net income				14,142					14,142
Other comprehensive income (loss):									
Foreign currency translation adjustment						(127)			(127)
Total comprehensive income									14,015
Tax benefit from exercise of stock options			4,595						4,595
Exercise of common stock options	393		5,392						5,392
Issuance of common stock to directors	3		120						120
Vesting of restricted stock units	6								
Stock-based compensation			7,006						7,006
Repurchase of common stock						(507)	(25,336)		(25,336)
Balance, January 2, 2011	20,212	\$ 20	\$ 173,143	\$ 63,141	\$ (66)	(5,673)	\$ (187,177)	\$	49,061

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

Table of Contents**BLUE NILE, INC.****Consolidated Statements of Cash Flows**
(In thousands)

	Year Ended January 2, 2011	Year Ended January 3, 2010	Year Ended January 4, 2009
Operating activities:			
Net income	\$ 14,142	\$ 12,800	\$ 11,630
Adjustments to reconcile net income to net cash provided by (used in) operating activities:			
Depreciation and amortization	3,129	2,593	2,110
Loss on disposal of property and equipment	26	63	20
Stock-based compensation	6,982	7,325	7,114
Deferred income taxes	(1,763)	(1,534)	(1,396)
Tax benefit from exercise of stock options	4,595	1,793	510
Excess tax benefit from exercise of stock options	(413)	(118)	(142)
Changes in assets and liabilities:			
Receivables	64	(126)	1,867
Inventories	(732)	(600)	2,072
Prepaid expenses and other assets	(78)	36	(21)
Accounts payable	14,199	13,794	(23,575)
Accrued liabilities	1,663	3,196	(2,967)
Deferred rent and other	(206)	(204)	(149)
Net cash provided by (used in) operating activities	41,608	39,018	(2,927)
Investing activities:			
Purchases of property and equipment	(1,843)	(2,345)	(2,010)
Proceeds from the sale of property and equipment			10
Purchase of short-term investments		(15,000)	
Proceeds from maturity of short-term investments	15,000		
Net cash provided by (used in) investing activities	13,157	(17,345)	(2,000)
Financing activities:			
Repurchase of common stock	(25,336)		(66,450)
Proceeds from stock option exercises	5,392	1,903	2,989
Excess tax benefit from exercise of stock options	413	118	142
Principal payments under long-term financing obligation	(44)	(40)	(38)
Net cash (used in) provided by financing activities	(19,575)	1,981	(63,357)
Effect of exchange rate changes on cash and cash equivalents	(78)	44	(58)
Net increase (decrease) in cash and cash equivalents	35,112	23,698	(68,342)
Cash and cash equivalents, beginning of period	78,149	54,451	122,793

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Cash and cash equivalents, end of period	\$ 113,261	\$ 78,149	\$ 54,451
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The accompanying notes are an integral part of these consolidated financial statements

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BLUE NILE, INC.

**Consolidated Statements of Cash Flows
(In thousands)**

	Year Ended January 2, 2011	Year Ended January 3, 2010	Year Ended January 4, 2009
Supplemental disclosure of cash flow information:			
Cash paid for income taxes	\$ 2,793	\$ 6,777	\$ 7,342
Cash paid for interest relating to long-term financing obligation	16	19	21

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

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BLUE NILE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1. Description of the Company and Summary of Significant Accounting Policies

The Company

Blue Nile, Inc. (the Company) is the leading online retailer of high quality diamonds and fine jewelry. In addition to sales of diamonds, fine jewelry and watches, the Company provides education, guidance and support to enable customers to more effectively learn about and purchase diamonds as well as classically styled fine jewelry. The Company, a Delaware corporation, based in Seattle, Washington, was formed in March 1999. The Company serves consumers in over 40 countries and territories all over the world and maintains its primary website at www.bluenile.com. The Company also operates the www.bluenile.co.uk and www.bluenile.ca websites.

Fiscal Year

The Company's fiscal year ends on the Sunday closest to December 31. Each fiscal year consists of four 13-week quarters, with one extra week added in the fourth quarter every five to six years. The Company's fiscal year 2008, which ended January 4, 2009, included one extra week in the fourth quarter as a result of the Company's 4-4-5 retail reporting calendar.

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries, Blue Nile, LLC (LLC), Blue Nile Worldwide, Inc. (Worldwide), and Blue Nile Jewellery, Ltd. (Jewellery). The Company, LLC and Worldwide are Delaware corporations located in Seattle, Washington. Jewellery is an Irish limited company located in Dublin, Ireland. All intercompany transactions and balances are eliminated in consolidation.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States (GAAP) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Some of the more significant estimates include the allowance for sales returns and assumptions used to determine stock-based compensation expense. Actual results could differ materially from those estimates.

Foreign Currency

The functional currency of Jewellery is the Euro. The assets and liabilities of Jewellery have been translated to U.S. dollars using the exchange rates effective on the balance sheet dates, while income and expense accounts are translated at the average rates in effect during the periods presented. The resulting translation adjustments are recorded in accumulated other comprehensive income (loss).

The Company offers customers the ability to transact in 24 foreign currencies. In addition, some of the Company's entities engage in transactions denominated in currencies other than the entity's functional currency. Gains or losses arising from these transactions are recorded in Other income, net in the consolidated statements of operations.

Recent Accounting Pronouncements

In January 2010, the Financial Accounting Standards Board issued Accounting Standards Update No. 2010-06 (ASU 2010-06), Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements. ASU 2010-06 requires reporting entities to make new disclosures about

Table of Contents**BLUE NILE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

recurring or nonrecurring fair value measurements including significant transfers into and out of Level 1 and Level 2 fair value measurements and information on purchases, sales, issuances, and settlements on gross basis in the reconciliation of Level 3 fair value measurements. ASU 2010-06 is effective for annual reporting periods beginning after December 15, 2009, except for Level 3 reconciliation disclosures which are effective for annual periods beginning after December 15, 2010. The adoption of ASU 2010-06 in the first quarter of 2010 did not have a material impact on the Company's financial statement disclosures.

Concentration of Risk

The Company maintains the majority of its cash, cash equivalents and short-term investments in accounts with four major financial institutions within and outside the United States, in the form of demand deposits, money market accounts, time deposits and other short-term investments. Deposits in these institutions may exceed the amounts of insurance provided, or deposits may not at all be covered by insurance. The Company has not experienced any losses on its deposits of cash, cash equivalents or short-term investments. The Company's trade accounts receivable are derived from credit card purchases from customers and the majority are settled within two business days.

The Company's ability to acquire diamonds and fine jewelry is dependent on its relationships with various suppliers from whom it purchases diamonds and fine jewelry. The Company has reached agreements with certain suppliers to provide access to their inventories of diamonds for its customers, but the terms of these agreements are limited and do not govern the purchase of diamonds for its inventory. The Company's inability to maintain these and other future diamond and fine jewelry supply relationships on commercially reasonable terms would cause its business to suffer and revenues to decline. Purchase concentration by major supply vendor in fiscal year 2010 with comparative information for fiscal years 2009 and 2008, is as follows:

	January 2, 2011 Payments	Year Ended January 3, 2010 Payments	January 4, 2009 Payments
Vendor A	12%	10%	9%
Vendor B	8%	7%	7%
Vendor C	8%	7%	6%
	28%	24%	22%

Cash and Cash Equivalents

The Company considers all highly liquid investments with maturities of three months or less, from the date of purchase, to be cash equivalents.

Short-term Investments

The Company classifies highly liquid investments with maturities greater than three months but less than one year as short-term investments. In August 2009, the Company purchased an investment in the form of a time deposit with a financial institution. The \$15.0 million investment matured in January 2010.

Inventories

The Company's diamond, fine jewelry and watch inventories are classified at the lower of cost or market, using the specific identification method for diamonds and weighted average cost method for fine jewelry and watches. The Company also lists loose diamonds and watches on its websites that are typically not included in inventory until the Company receives a customer order for those diamonds or watches. Upon receipt of a

Table of Contents**BLUE NILE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

customer order, the Company purchases a specific diamond or watch and records it in inventory until it is delivered to the customer, at which time the revenue from the sale is recognized and inventory is relieved.

Property and Equipment

Property and equipment are stated at cost less accumulated depreciation. Maintenance and repairs are expensed as incurred. Depreciation is calculated on a straight-line basis over the estimated useful lives of the related assets. The cost and related accumulated depreciation of assets sold or otherwise disposed of are removed from the accounts and the related gain or loss is reported in the statement of operations. Estimated useful lives by major asset category are as follows:

Asset	Life (in years)
Software	2-5
Computers and equipment	3-5
Leasehold improvements	Shorter of lease term or asset life
Building	Shorter of lease term or asset life
Furniture and fixtures	5-7

Capitalized Software

The Company capitalizes costs to develop its websites and internal-use software and amortizes such costs on a straight-line basis over the estimated useful life of the software once it is available for use.

Impairment of Long-Lived Assets

The Company reviews the carrying value of its long-lived assets, including property and equipment and definite-lived intangible assets, whenever events or changes in circumstances indicate that the carrying value may not be recoverable. To the extent the estimated future cash inflows attributable to the assets, less estimated future cash outflows, are less than the carrying amount, an impairment loss would be recognized.

Intangible Assets

Intangible assets are recorded at cost and consist primarily of the costs incurred to acquire licenses and other similar agreements with finite lives, which were acquired in October 2004 and April 2009. The gross carrying amount of these licenses was \$0.5 million as of January 2, 2011 and \$0.5 million as of January 3, 2010. Accumulated amortization was \$260,000 and \$209,000 as of January 2, 2011 and January 3, 2010, respectively. Amortization expense was \$51,000 in the fiscal year ended January 2, 2011 and \$46,000 in the fiscal year ended January 3, 2010. Amortization expense is estimated to be \$51,000 in fiscal 2011, \$51,000 in fiscal 2012, \$48,000 in fiscal 2013, \$30,000 in fiscal 2014, and \$15,000 in fiscal 2015.

Intangible assets that are not being amortized relate to the Company's domain names, with total carrying amounts of \$33,000 as of January 2, 2011 and January 3, 2010 respectively. These assets are tested for impairment annually and more frequently if certain circumstances indicate that impairment may have occurred.

Fair Value of Financial Instruments

The carrying amounts for the Company's cash, short-term investments, accounts receivable, accounts payable and accrued liabilities approximate fair value due to their short maturities.

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BLUE NILE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Treasury Stock

Treasury stock is recorded at cost and consists primarily of the repurchase of the Company's common stock in the open market.

Income Taxes

Deferred tax assets and liabilities are determined based on the differences between financial reporting and tax bases of assets and liabilities and are measured using the tax rates that will be in effect when the differences are expected to reverse. Future tax benefits, such as return reserves, are recognized to the extent that realization of such benefits is considered to be more likely than not.

The Company utilizes a two-step approach to recognizing and measuring uncertain tax positions. The first step is to evaluate the tax position for recognition by determining if the weight of available evidence indicates it is more likely than not that the position will be sustained on audit, including resolution of related appeals or litigation processes, if any. The second step is to measure the tax benefit as the largest amount which is more than 50% likely of being realized upon ultimate settlement. The Company considers many factors when evaluating and estimating tax positions and tax benefits, which may require periodic adjustments and which may not accurately forecast actual outcomes. The Company does not have any unrecognized tax benefits. If interest and penalties related to unrecognized tax benefits were incurred, such amounts would be included in the Company's provision for income taxes.

Revenue Recognition

Net sales consist of products sold via the Internet and shipping revenue, net of estimated returns and promotional discounts and excluding sales taxes. The Company recognizes revenue when all of the following have occurred: persuasive evidence of an agreement with the customer exists, delivery has occurred or services have been rendered, the selling price is fixed or determinable and collectability of the selling price is reasonably assured. The Company evaluates whether it is appropriate to record the gross amount of product sales and related costs or the net amount earned. Revenue is recorded at the gross amount when the Company is the primary obligor, is subject to inventory and credit risk, has latitude in establishing price and product specification, or has most of these indicators. When the Company is not primarily obligated and has no latitude in establishing the price, revenue will be recorded at the net amount earned.

The Company requires payment at the point of sale. Amounts received before the customer assumes the risk of loss are not recorded as revenue. For sales to customers in the U.S., Canada and the E.U., the Company recognizes revenue when delivery has occurred. For international sales, other than to Canada and the E.U., revenue is recognized upon shipment. The Company generally offers a return policy of 30 days and provides an allowance for sales returns during the period in which the sales are made. At January 2, 2011 and January 3, 2010, the reserve for sales returns was \$1.0 million and \$0.9 million, respectively, and was recorded as an accrued liability. Sales and cost of sales reported in the consolidated statements of operations are reduced to reflect estimated returns. The estimates are based on the Company's historical product return rates and current economic conditions.

The Company generally does not extend credit to customers, except through third party credit cards. The majority of sales are through credit cards, and accounts receivable are composed primarily of amounts due from financial institutions related to credit card sales. The Company does not maintain an allowance for doubtful accounts because

payment is typically received within two business days after the sale is complete.

Shipping and Handling Costs

The Company's shipping and handling costs primarily include payments to third-parties for shipping merchandise to the Company's customers. Shipping and handling costs of \$3.2 million, \$2.8 million and

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BLUE NILE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

\$3.0 million in the fiscal years ended January 2, 2011, January 3, 2010 and January 4, 2009, respectively, were included in cost of sales.

Cost of Sales

Cost of sales consists of the cost of merchandise sold to customers, inbound and outbound shipping costs, depreciation on assembly related costs, insurance on shipments and the costs incurred to set diamonds into ring, earring and pendant settings, including labor and related facility costs.

Selling, General and Administrative Expenses

Selling, general and administrative expenses consist primarily of payroll and related benefit costs for the Company's employees, marketing costs, stock-based compensation and credit card fees. These expenses also include certain facility-related costs, and fulfillment, customer service, technology and depreciation expenses, as well as professional fees and other general corporate expenses.

Fulfillment costs include costs incurred in operating and staffing the fulfillment center, including costs attributable to receiving, inspecting and warehousing inventories and picking, packaging and preparing customers' orders for shipment. Fulfillment costs in the years ended January 2, 2011, January 3, 2010 and January 4, 2009 were approximately \$3.3 million, \$3.0 million and \$2.9 million, respectively.

The Company has procedures in place to detect and prevent credit card fraud because the Company has exposure to losses from fraudulent charges. The Company records a reserve for fraud losses based on the Company's historical rate of such losses. This reserve is recorded as an accrued liability and amounted to \$0.1 million at January 2, 2011 and \$0.09 million at January 3, 2010.

Marketing

Marketing costs are expensed as incurred. Costs associated with web portal advertising contracts are amortized over the period such advertising is expected to be used. Costs of advertising associated with radio, print and other media are expensed when such services are used. Marketing expense for the years ended January 2, 2011, January 3, 2010 and January 4, 2009 was approximately \$14.5 million, \$11.6 million and \$12.4 million, respectively.

Stock-Based Compensation

The Company measures compensation cost for all stock options and restricted stock units granted based on fair value on the date of the grant. Stock-based compensation expense, net of estimated forfeitures, is recognized on a straight-line basis over the vesting period for each stock option or restricted stock unit grant. The fair value of each stock option granted is estimated on the grant date using the Black-Scholes-Merton option valuation model. The fair value of each restricted stock unit is based on the fair market value of the Company's common stock on the date of the grant. See Note 6 for additional details.

Note 2. Inventories

Inventories consist of the following (in thousands):

	January 2, 2011	January 3, 2010
Loose diamonds	\$ 732	\$ 297
Fine jewelry, watches and other	19,434	19,137
	\$ 20,166	\$ 19,434

Table of Contents**BLUE NILE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Note 3. Property and Equipment**

Property and equipment consist of the following (in thousands):

	January 2, 2011	January 3, 2010
Computers and equipment	\$ 3,525	\$ 3,902
Software and website development	9,855	8,343
Leasehold improvements	4,940	5,467
Furniture and fixtures	682	679
Building	940	940
	19,942	19,331
Less: accumulated depreciation and amortization	(13,785)	(11,999)
Property and equipment, net	\$ 6,157	\$ 7,332

Total depreciation expense was \$3.1 million, \$2.5 million and \$2.1 million in the years ended January 2, 2011, January 3, 2010 and January 4, 2009, respectively.

Capitalized software costs include external direct costs and internal direct labor and related employee benefits costs of developing software for internal use. Amortization begins in the period in which the software is ready for its intended use. The Company had \$2.7 million of unamortized computer software and website development costs at January 2, 2011 and January 3, 2010. Depreciation and amortization of capitalized software and website development costs was \$1.6 million, \$1.1 million and \$0.7 million in the years ended January 2, 2011, January 3, 2010 and January 4, 2009, respectively.

Note 4. Commitments and Contingencies***Leases***

The Company leases its office and warehouse facilities and some equipment under non-cancelable lease agreements with initial terms that generally range from three to seven years. Certain of the leases include renewal provisions at the Company's option. At the inception of the lease, the Company evaluates each agreement to determine whether the lease will be accounted for as an operating or capital lease. The term of the lease used for this evaluation includes renewal option periods only in instances in which the exercise of the renewal option can be reasonably assured and failure to exercise such option would result in an economic penalty. The office and warehouse leases contain rent escalation clauses and rent holidays. Rent expense is recorded on a straight-line basis over the lease term with the difference between the rent paid and the straight-line rent expense recorded as a deferred rent liability. Lease incentive payments received from the landlord are recorded as deferred rent liabilities and are amortized on a straight-line basis over the lease term as a reduction in rent. At January 2, 2011 and January 3, 2010, the deferred rent balance related to lease incentives was \$0.1 million and \$0.3 million, respectively.

During 2007, the Company made tenant improvements to its U.S. fulfillment center. Due to its financial involvement in the construction of the leased property, the Company recorded the building as property and equipment during the construction period. Upon completion, the transaction did not meet the criteria for sale-leaseback accounting, and accordingly, has been recorded as a long-term financing obligation.

Table of Contents**BLUE NILE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Future minimum lease payments at January 2, 2011 are as follows (in thousands):

	Financing Obligation	Operating Leases
2011	\$ 61	\$ 299
2012	68	181
2013	68	179
2014	54	133
Total minimum lease payments	251	\$ 792
Less: amounts representing interest	(30)	
Present value of minimum lease payments	221	
Residual value	575	
Less: current maturities	(48)	
Total long-term financing obligation less current maturities	\$ 748	

As of January 2, 2011 and January 3, 2010, assets under the long-term financing obligation amounted to \$0.8 million net of accumulated depreciation of \$172,000 and \$121,000, respectively. Such assets are classified within property and equipment, net, in the accompanying balance sheets. The residual value of the long-term financing obligation represents the estimated fair value of the financing at the end of the Company's lease term. Rent expense, which includes certain common area maintenance costs, was approximately \$0.6 million for each of the fiscal years ended January 2, 2011, January 3, 2010 and January 4, 2009.

Litigation

The Company is currently involved with a claim with respect to intellectual property arising from the ordinary course of business, and may be subject from time to time to various proceedings, lawsuits, disputes or claims. Although the Company cannot predict with assurance the outcome of any such claim or litigation, it does not believe there are currently any such actions that, if resolved unfavorably, would have a material impact on the Company's financial condition or results of operations.

Note 5. Preferred Stock

The Company has 5,000,000 shares of undesignated preferred stock authorized for future issuance. Shares of preferred stock may be issued from time to time in one or more series, with designations, preferences, and limitations established by the Company's board of directors.

Note 6. Stock-Based Compensation

Stock Option Plans

The Company's 1999 Equity Incentive Plan (1999 Plan) provides for the grant of incentive stock options, non-statutory stock options, stock bonuses and restricted stock awards, which may be granted to employees, including officers, non-employee directors and consultants. Options granted under the 1999 Plan generally provide for 25% vesting on the first anniversary from the date of grant with the remainder vesting monthly over the subsequent three years and expire 10 years from the date of grant. Options granted under the 1999 Plan were generally granted at fair value on the date of the grant. As of May 19, 2004, the effective date of the Company's initial public offering, no additional awards were granted under the 1999 Plan.

The Company's 2004 Equity Incentive Plan (2004 Plan) provides for the grant of non-statutory stock options, restricted stock awards, stock appreciation rights, restricted stock units and other forms of equity

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BLUE NILE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

compensation, which may be granted to employees, including officers, non-employee directors and consultants. As of January 2, 2011, the Company reserved 4,798,264 shares of common stock for future grants under the 2004 Plan, which amount will be increased annually on the first day of each fiscal year, up to and including 2014, by five percent of the number of shares of common stock outstanding on such date unless a lower number of shares is approved by the board of directors.

Options granted under the 2004 Plan generally provide for 25% vesting on the first anniversary of the date of grant with the remainder vesting monthly over the subsequent three years, and generally expire 10 years from the date of grant.

In the first quarter of 2010, the Company granted restricted stock units (RSUs) to an executive under the 2004 Equity Incentive Plan. The RSUs had a grant date fair value of \$49,000 and vest 25% per year over four years, commencing on the first anniversary of the grant date. Each RSU is converted to one share of common stock when it vests.

The Company's 2004 Non-Employee Directors' Stock Option Plan (Directors' Plan) provides for the automatic grant of non-statutory stock options to purchase shares of common stock to non-employee directors. As of January 2, 2011, the Company reserved 413,401 shares of common stock for future grants under the Directors' Plan, which amount will be increased annually on the first day of each fiscal year, up to and including 2014, by the number of shares of common stock subject to options granted during the prior calendar year unless a lower number of shares is approved by the board of directors. There were 15,000 options granted under the Directors' Plan in the year ended January 2, 2011.

Employee Stock Purchase Plans

In April 2004, the Company adopted the 2004 Employee Stock Purchase Plan (the Purchase Plan). As of January 2, 2011, 1,000,000 shares of common stock are authorized to be sold under the Purchase Plan. Commencing on the first day of the fiscal year in which the Company first makes an offering under the Purchase Plan, this amount will be increased annually for 20 years. The increase in amount is the lesser of 320,000 shares or one and one half percent of the number of shares of common stock outstanding on each such date, unless a lower number of shares is approved by the board of directors. The Purchase Plan is intended to qualify as an employee stock purchase plan within the meaning of Section 423 of the Internal Revenue Code. As of January 2, 2011, no shares of common stock have been offered for sale under the Purchase Plan.

Option Grants to Non-Employees

The Company accounts for equity instruments issued to non-employees at their fair value on the measurement date.

Stock-Based Compensation Expense

The fair value of each stock option granted is estimated on the measurement date, which is typically the grant date, using the Black-Scholes-Merton option valuation model. The assumptions used to calculate the fair value of options granted are evaluated and revised, as necessary, to reflect market conditions and the Company's experience.

Table of Contents**BLUE NILE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The fair values of the stock options were estimated at the grant date with the following weighted average assumptions:

	January 2, 2011	Year Ended January 3, 2010	January 4, 2009
Expected term	4.0 years	4.0 years	4.0 years
Expected volatility	57.9%	55.1%	48.1%
Expected dividend yield	0.0%	0.0%	0.0%
Risk-free interest rate	1.2%	1.4%	2.5%
Estimated weighted average fair value per option granted	\$ 21.60	\$ 11.32	\$ 17.23

Expected Term This is the estimated period of time until exercise and is based primarily on historical experience for options with similar terms and conditions, giving consideration to future expectations. The Company also considers the expected terms of other companies that have similar contractual terms, expected stock volatility and employee demographics.

Expected Volatility This is based on the Company's historical stock price volatility.

Expected Dividend Yield The Company has not paid dividends in the past and does not expect to pay dividends in the near future.

Risk-Free Interest Rate This is the rate on nominal U.S. Government Treasury Bills with lives commensurate with the expected term of the options on the date of grant.

The fair value of each restricted stock unit is based on the fair market value of the Company's common stock on the date of the grant.

The Company recognizes compensation expense on a straight-line basis over the requisite service period for each stock option and restricted stock unit grant expected to vest, with forfeitures estimated at the date of grant based on the Company's historical experience and future expectations.

The following table represents total stock-based compensation expense recognized in the consolidated financial statements (in thousands):

	January 2, 2011	Year Ended January 3, 2010	January 4, 2009
Stock-based compensation expense in selling, general and administrative expenses	\$ 6,771	\$ 7,088	\$ 6,905
Stock-based compensation expense in cost of sales	91	77	79

Total stock-based compensation expense in the consolidated statements of operations	\$ 6,862	\$ 7,165	\$ 6,984
Total related tax benefit	\$ 2,354	\$ 2,508	\$ 2,437
Stock-based compensation capitalized	\$ 144	\$ 96	\$ 96

Stock-based compensation capitalized is included in property and equipment, net, in the consolidated balance sheets as a component of the cost capitalized for website development and the development of software for internal use. As of January 2, 2011, the Company had total unrecognized compensation costs related to unvested stock options and restricted stock units of \$9.8 million, before income taxes. The Company expects to recognize this cost over a weighted average period of 2.4 years for stock options and 0.6 years for restricted stock units.

Table of Contents**BLUE NILE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The following summarizes all stock option transactions from December 30, 2007, through January 2, 2011:

	Options (In thousands)	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Total Intrinsic Value (In thousands)
Balance, December 30, 2007	2,037	32.84		
Granted	520	43.11		
Exercised	(142)	21.01		
Canceled	(125)	60.79		
Balance, January 4, 2009	2,290	34.38		
Granted	562	25.88		
Exercised	(147)	12.92		
Canceled	(69)	46.80		
Balance, January 3, 2010	2,636	33.44		
Granted	316	47.79		
Exercised	(393)	13.71		
Canceled	(114)	42.59		
Balance, January 2, 2011	2,445	\$ 38.04	6.41	\$ 52,228
Vested and expected to vest at January 2, 2011	2,367	\$ 38.00	6.33	\$ 50,793
Exercisable at January 2, 2011	1,736	\$ 37.13	5.60	\$ 39,318

The following table summarizes additional information about stock options outstanding at January 2, 2011:

Range of Exercise Price	Options (In thousands)	Outstanding Weighted Average Remaining		Exercisable Weighted Average Exercise Price	
		Contractual Life (In years)	Exercise Price	Options (In thousands)	Exercise Price

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\$0.25	\$30.00	782	5.86	\$ 23.56	550	\$	24.48
\$30.04	\$32.97	661	5.12	31.84	661		31.84
\$33.10	\$49.11	692	7.84	44.15	298		41.96
\$49.79	\$99.98	310	7.00	74.09	227		76.91
		2,445	6.37	38.04	1,736		37.13

Table of Contents**BLUE NILE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

A summary of restricted stock unit activity from January 4, 2009 through January 2, 2011 is as follows:

	RSUs (In thousands)	Weighted Average Grant Date Fair Value	Weighted Average Remaining Contractual Term (In years)	Aggregate Intrinsic Value (In thousands)
Balance, January 4, 2009		\$		
Granted	12	21.22		
Vested				
Canceled				
Balance, January 3, 2010	12	\$ 21.22		
Granted	1	49.49		
Vested	(6)	21.22		
Canceled	(1)	21.22		
Balance, January 2, 2011	6	\$ 25.61	0.38	\$ 367
Expected to vest at January 2, 2011	6	\$ 25.61	0.38	\$ 367

The aggregate intrinsic values in the tables above are before applicable income taxes and represent the amounts recipients would have received if all options had been exercised or restricted stock units had been converted on the last business day of the period indicated, based on the Company's closing stock price.

The total intrinsic value of options exercised was \$15.4 million, \$6.2 million and \$3.3 million in the years ended January 2, 2011, January 3, 2010 and January 4, 2009, respectively. During the years ended January 2, 2011, January 3, 2010 and January 4, 2009, the total fair value of options vested was \$6.8 million, \$7.4 million and \$6.6 million, respectively.

Note 7. Common Stock

On February 9, 2010, the Company's board of directors authorized the repurchase of up to \$100 million of its common stock within the 24-month period following the approval date of such additional repurchase. In the year ended January 2, 2011, the Company repurchased 0.5 million shares of the Company's common stock for an aggregate purchase price of approximately \$25.3 million. In the year ended January 3, 2010, the Company did not repurchase shares of the Company's common stock. In the year ended January 4, 2009, the Company repurchased 1.6 million shares of the Company's common stock for an aggregate purchase price of approximately \$66.5 million.

Note 8. Employee Benefit Plan

The Company has a defined contribution plan pursuant to Section 401(k) of the Internal Revenue Code covering all eligible officers and employees. The Company provides a discretionary matching contribution, which has generally been \$0.50 for every \$1.00 contributed by the employee up to 4% of each employee's salary. Such contributions were approximately \$0.2 million for each of the years ended January 2, 2011, January 3, 2010 and January 4, 2009.

Table of Contents**BLUE NILE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Note 9. Income Taxes**

The expense (benefit) for income taxes consists of the following (in thousands):

	January 2, 2011	Year Ended January 3, 2010	January 4, 2009
Current income tax expense	\$ 4,564	\$ 6,619	\$ 7,112
Tax benefit from stock option exercises recorded in equity	4,595	1,793	510
Deferred income tax (benefit) expense:			
Other, net	(1,763)	(1,534)	(1,396)
Total income tax expense	\$ 7,396	\$ 6,878	\$ 6,226

A reconciliation of the statutory Federal income tax rate to the effective tax rate is as follows:

Statutory Federal income tax rate	35.0%	35.0%	35.0%
Other, net	(0.7) %	0.0%	(0.1) %
Effective tax rate	34.3%	35.0%	34.9%

Deferred income taxes reflect the net tax effect of temporary differences between amounts recorded for financial reporting purposes and amounts used for tax purposes. The major components of deferred tax assets are as follows (in thousands):

	Year Ended	
	January 2, 2011	January 3, 2010
Deferred tax assets:		
Current:		
Reserves and allowances	\$ 503	\$ 453
Deferred rent	30	72
Other	241	203
Noncurrent:		
Stock options	8,941	7,156
Deferred rent	29	59
Financing obligation	262	279
Other	38	38

Gross deferred tax assets	10,044	8,260
Deferred tax liabilities:		
Current:		
Prepaid expenses	(217)	(279)
Noncurrent:		
Leased building	(269)	(287)
Excess of book over tax depreciation and amortization	(577)	(476)
Gross deferred tax liabilities	(1,063)	(1,042)
Net deferred tax assets	\$ 8,981	\$ 7,218

Table of Contents**BLUE NILE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The Company had no valuation allowance against its deferred tax asset balances at January 2, 2011 and January 3, 2010 because it believes these deferred tax assets are more likely than not to be fully realized. Income taxes payable at January 2, 2011 and January 3, 2010 were \$2.2 million and \$0.5 million, respectively, and were included in accrued liabilities.

The Company has not provided for deferred taxes on unremitted earnings of subsidiaries outside the United States where such earnings are permanently reinvested. At January 2, 2011, unremitted earnings of foreign subsidiaries were approximately \$0.6 million. The amount of unrecognized deferred tax liability associated with these unremitted earnings is approximately \$0.2 million. If these earnings were distributed in the form of dividends or otherwise, the Company would be subject to U.S. income taxes less an adjustment for applicable foreign tax credits.

The Company is no longer subject to U.S. federal income tax examinations by tax authorities for years before 2007.

The tax benefit realized for the tax deduction from stock option exercises totaled \$5.3 million, \$2.1 million and \$0.9 million for the years ended January 2, 2011, January 3, 2010 and January 4, 2009, respectively.

Note 10. Income Per Share

Basic net income per share is based on the weighted average number of common shares outstanding. Diluted net income per share is based on the weighted average number of common shares and common share equivalents outstanding. Common share equivalents included in the computation represent shares issuable upon assumed exercise of outstanding stock options and conversion of unvested restricted stock units except when the effect of their inclusion would be antidilutive.

The following table sets forth the computation of basic and diluted net income per share (in thousands, except per share data):

	January 2, 2011	Year Ended January 3, 2010	January 4, 2009
Net income	\$ 14,142	\$ 12,800	\$ 11,630
Weighted average common shares outstanding	14,446	14,534	14,925
Basic net income per share	\$ 0.98	\$ 0.88	\$ 0.78
Dilutive effect of stock options and restricted stock units	634	682	580
Common stock and common stock equivalents	15,080	15,216	15,505
Diluted net income per share	\$ 0.94	\$ 0.84	\$ 0.75

The following is a summary of the securities outstanding during the respective periods that have been excluded from the calculations because the effect on net income per share would have been antidilutive (in thousands):

	January 2, 2011	Year Ended January 3, 2010	January 4, 2009
Stock options	595	757	606

Note 11. Segment Information

The Company's only operating segment is online retail jewelry. The Company sells jewelry to customers within and outside the United States. No customer accounted for 10% or more of the Company's revenues.

Table of Contents**BLUE NILE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Net sales were attributed on the basis of the country to where the product was shipped. Revenue from customers in individual foreign countries was not material to the financial statements.

The tables below represent information by geographic area (in thousands):

	January 2, 2011	Year Ended January 3, 2010	January 4, 2009
Net sales to customers:			
United States	\$ 289,589	\$ 268,898	\$ 267,670
Other countries	43,300	33,236	27,659
Total	\$ 332,889	\$ 302,134	\$ 295,329

	January 2, 2011	Year Ended January 3, 2010	January 4, 2009
Long-lived assets:			
United States	\$ 6,009	\$ 7,044	\$ 7,148
Other countries	148	288	410
Total	\$ 6,157		