

SHUTTERFLY INC  
Form 10-Q  
August 01, 2007

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**WASHINGTON, DC 20549**  
**FORM 10-Q**  
**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE**  
**SECURITIES EXCHANGE ACT OF 1934**  
**For the quarterly period ended June 30, 2007**  
**Commission file number 001-33031**  
**SHUTTERFLY, INC.**  
(Exact Name of Registrant as Specified in Its Charter)

**Delaware**  
(State or Other Jurisdiction of  
Incorporation or Organization)

**94-3330068**  
(IRS Employer  
Identification No.)

**2800 Bridge Parkway, Suite 101**  
**Redwood City, California**  
(Address of Principal Executive Offices)

**94065**  
(Zip Code)

**(650) 610-5200**

(Registrant's Telephone Number, Including Area Code)

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 is a large accelerated filer, an accelerated filer or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer ☐ Accelerated Filer ☐ Non-Accelerated Filer ☐

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

As of July 26, 2007, 24,338,045 shares of the Registrant's common stock at \$0.0001 par value were outstanding.

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

|   | <b>June 30,<br/>2007</b> | <b>December<br/>31,<br/>2006</b> |
|---|--------------------------|----------------------------------|
| <b>ASSETS</b>   |                          |                                  |
| Current assets:   |                          |                                  |
| Cash and cash equivalents   | \$ 104,011               | \$ 119,051                       |
| Accounts receivable, net  | 1,708                    | 2,164                            |
| Inventories   | 2,042                    | 2,493                            |
| Deferred tax asset, current portion   | 2,214                    | 2,129                            |
| Prepaid expenses and other current assets   | 3,039                    | 2,760                            |
| Total current assets  | 113,014                  | 128,597                          |
| Property and equipment, net   | 39,586                   | 30,919                           |
| Goodwill and intangible assets, net   | 2,968                    | 1,396                            |
| Deferred tax asset, net of current portion  | 21,547                   | 18,754                           |
| Other assets  | 658                      | 494                              |
| Total assets  | \$ 177,773               | \$ 180,160                       |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>   |                          |                                  |
| Current liabilities:  |                          |                                  |
| Accounts payable  | \$ 3,179                 | \$ 9,385                         |
| Accrued liabilities   | 13,094                   | 8,808                            |
| Deferred revenue  | 6,743                    | 6,278                            |
| Current portion of capital lease obligations  | 1,791                    | 1,961                            |
| Total current liabilities   | 24,807                   | 26,432                           |
| Other liabilities   | 931                      | 660                              |
| Capital lease obligations, less current portion   | 657                      | 1,742                            |
| Total liabilities   | 26,395                   | 28,834                           |
| Commitments and contingencies (Note 5)  |                          |                                  |
| Stockholders' equity  |                          |                                  |
| Undesignated preferred stock, \$0.0001 par value; 5,000 shares authorized; no shares issued and outstanding   |                          |                                  |
| Common stock, \$0.0001 par value; 100,000 shares authorized; 24,301 and 23,705 shares issued and outstanding on June 30, 2007 and December 31, 2006, respectively | 2                        | 2                                |
| Additional paid-in capital  | 185,313                  | 181,890                          |
| Accumulated other comprehensive loss  | (18)                     | (35)                             |
| Deferred stock-based compensation   | (79)                     | (191)                            |

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|  |            |            |
|--|------------|------------|
| Accumulated deficit                        | (33,840)   | (30,340)   |
| Total stockholders' equity                 | 151,378    | 151,326    |
| Total liabilities and stockholders' equity | \$ 177,773 | \$ 180,160 |

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

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

|   | <b>Three Months Ended<br/>June 30,</b> |             | <b>Six Months Ended<br/>June 30,</b> |             |
|---|--|-------------|--------------------------------------|-------------|
|   | <b>2007</b>                            | <b>2006</b> | <b>2007</b>                          | <b>2006</b> |
| Net revenues  | \$ 29,877                              | \$ 19,637   | \$ 56,582                            | \$ 36,520   |
| Cost of revenues(1)                                   | 14,832                                 | 9,756       | 27,866                               | 18,505      |
| Gross profit  | 15,045                                 | 9,881       | 28,716                               | 18,015      |
| Operating expenses(1):                                |  |             |                                      |             |
| Technology and development                            | 6,641                                  | 4,271       | 12,455                               | 8,254       |
| Sales and marketing                                   | 7,199                                  | 4,504       | 12,379                               | 8,197       |
| General and administrative                            | 6,741                                  | 4,301       | 12,705                               | 7,698       |
|   | 20,581                                 | 13,076      | 37,539                               | 24,149      |
| Loss from operations                                  | (5,536)                                | (3,195)     | (8,823)                              | (6,134)     |
| Interest expense                                      | (39)                                   | (70)        | (93)                                 | (148)       |
| Other income (expense), net                           | 1,415                                  | 49          | 2,902                                | 524         |
| Loss before income taxes                              | (4,160)                                | (3,216)     | (6,014)                              | (5,758)     |
| Benefit from income taxes                             | 1,721                                  | 1,123       | 2,514                                | 2,100       |
| Net loss  | \$ (2,439)                             | \$ (2,093)  | \$ (3,500)                           | \$ (3,658)  |
| Net loss per share basic and diluted                  | \$ (0.10)                              | \$ (0.54)   | \$ (0.15)                            | \$ (0.95)   |
| Weighted-average shares outstanding basic and diluted | 24,136                                 | 3,885       | 24,034                               | 3,858       |

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

|                            |       |       |       |       |
|----------------------------|-------|-------|-------|-------|
| Cost of revenues           | \$ 39 | \$ 21 | \$ 77 | \$ 32 |
| Technology and development | 192   | 117   | 456   | 260   |
| Sales and marketing        | 139   | 114   | 314   | 201   |
| General and administrative | 553   | 210   | 938   | 380   |

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

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

|  | <b>Six Months Ended<br/>June 30,</b> |             |
|--|--------------------------------------|-------------|
|  | <b>2007</b>                          | <b>2006</b> |
| <b>Cash flows from operating activities:</b>   |                                      |             |
| Net loss   | \$ (3,500)                           | \$ (3,658)  |
| Adjustments to reconcile net loss to net cash provided by (used in) operating activities |                                      |             |
| Depreciation and amortization  | 7,468                                | 4,556       |
| Amortization of intangible assets  | 77                                   | 158         |
| Amortization of stock-based compensation, net of cancellations                           | 1,785                                | 873         |
| Change in carrying value of preferred stock warrant liability                            |                                      | 127         |
| Loss on disposal of inventory and property and equipment                                 |                                      | 1           |
| Deferred income taxes  | (2,887)                              | (2,093)     |
| Changes in operating assets and liabilities  |                                      |             |
| Inventories  | 456                                  | 325         |
| Accounts receivable, net   | 456                                  | 90          |
| Prepaid expenses and other current assets  | (279)                                | (356)       |
| Other assets   | (164)                                | 4           |
| Accounts payable   | (6,206)                              | (1,410)     |
| Accrued and other liabilities  | 4,541                                | (7,210)     |
| Deferred revenue   | 465                                  | 497         |
| Net cash provided by (used in) operating activities                                      | 2,212                                | (8,096)     |
| <b>Cash flows from investing activities:</b>   |                                      |             |
| Purchases of property and equipment and acquisition of business                          | (17,701)                             | (6,341)     |
| Net cash used in investing activities  | (17,701)                             | (6,341)     |
| <b>Cash flows from financing activities:</b>   |                                      |             |
| Principal payments of capital lease obligations  | (1,306)                              | (757)       |
| Payments of IPO related costs  |                                      | (40)        |
| Proceeds from issuance of common stock upon exercise of stock options                    | 1,755                                | 59          |
| Repurchases of common stock  |                                      | (11)        |
| Net cash provided by (used in) financing activities                                      | 449                                  | (749)       |
| Net decrease in cash and cash equivalents  | (15,040)                             | (15,186)    |
| Cash and cash equivalents, beginning of period   | 119,051                              | 39,153      |
| Cash and cash equivalents, end of period   | \$ 104,011                           | \$ 23,967   |

**Supplemental disclosures of cash flow information**

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|  |    |     |    |    |
|--|----|-----|----|----|
| Cash paid during the period for interest     | \$ | 114 | \$ | 92 |
| Cash paid during the period for income taxes |    | 760 |    |    |

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

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**SHUTTERFLY, INC.**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(In thousands, except per share amounts and percentages)**

**Note 1 The Company and Summary of Significant Accounting Policies**

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

On September 29, 2006, the Company completed its initial public offering (IPO) in which the Company sold 5,800 shares at a price to the public of \$15.00 per share. As a result of the IPO, a total of \$87.0 million in gross proceeds was raised, with net proceeds to the Company of \$78.5 million after deducting underwriting fees and commissions of \$6.1 million and other offering costs of \$2.4 million. Upon the closing of the IPO, all shares of the Company's outstanding redeemable convertible preferred stock automatically converted into an aggregate of 13,863 common shares.

***Basis of Presentation***

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and, accordingly, do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. The accompanying unaudited condensed consolidated financial statements include the accounts of Shutterfly, Inc. and its wholly owned subsidiary. In the opinion of management, all adjustments, consisting primarily of normal recurring accruals, considered necessary for a fair statement of the Company's results of operations for the interim periods reported and of its financial condition as of the date of the interim balance sheet have been included. Operating results for the three and six months ended June 30, 2007 are not necessarily indicative of the results that may be expected for the year ending December 31, 2007 or for any other period.

The year-end condensed consolidated balance sheet data was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America. These unaudited interim condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes for the year ended December 31, 2006 included in the Company's Form 10-K.

***Principles of Consolidation***

The accompanying condensed consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary acquired in 2005. The wholly-owned subsidiary was dissolved in 2006 and was merged into the Company. All intercompany transactions and balances have been eliminated.

***Use of Estimates***

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements, as well as the reported amounts of revenues and expenses during the reporting period. Significant items subject to such estimates and assumptions include intangible assets valuation, legal contingencies, deferred tax asset valuation allowance, and the valuation of equity instruments. Actual results could differ from these estimates.

***Stock-Based Compensation***

Prior to January 1, 2006, the Company accounted for stock-based employee compensation arrangements in accordance with the provisions of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB No. 25), and related interpretations, and followed the disclosure provisions of Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation (SFAS No. 123). Under APB No. 25, compensation expense is based on the difference, if any, on the date of the grant, between the fair value of the Company's stock and the exercise price. Employee stock-based compensation determined under APB No. 25 is recognized based on guidance provided in Financial Accounting Standards Board Interpretation



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**SHUTTERFLY, INC.**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(In thousands, except per share amounts and percentages)**

No. 28, Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans ( FIN 28 ), which provides for accelerated expensing over the option vesting period.

The Company accounts for equity instruments issued to non-employees in accordance with the provisions of SFAS No. 123, Emerging Issues Task Force No. 96-18, Accounting for Equity Instruments that are Issued to Other than Employees for Acquiring, or in Conjunction with Selling, Goods or Services ( EITF 96-18 ), and FIN 28.

Effective January 1, 2006, the Company adopted the fair value provisions of Statement of Financial Accounting Standards No. 123R, Share-Based Payment ( SFAS No. 123R ), which supersedes its previous accounting under APB 25. SFAS No. 123R requires the recognition of compensation expense, using a fair-value based method, for costs related to all share-based payments including stock options. SFAS No. 123R requires companies to estimate the fair value of share-based payment awards on the date of grant using an option-pricing model. The Company adopted SFAS No. 123R using the prospective transition method, which requires that for nonpublic entities that used the minimum value method for either pro forma or financial statement recognition purposes, SFAS No. 123R shall be applied to option grants after the required effective date. For options granted prior to the SFAS No. 123R effective date, for which the requisite service period has not been performed as of January 1, 2006, the Company will continue to recognize compensation expense on the remaining unvested awards under the intrinsic-value method of APB 25. In addition, the Company will continue amortizing those awards valued prior to January 1, 2006 utilizing an accelerated amortization schedule, while all option grants valued after January 1, 2006 will be expensed on a straight-line basis over the requisite period.

In November 2005, the Financial Accounting Standards Board ( FASB ) issued FASB Staff Position No. FAS 123R-3, Transition Election Related to Accounting for Tax Effects of Share-Based Payment Awards. The Company elected to adopt the prospective transition method provided in the FASB Staff Position for calculating the tax effects of stock-based compensation pursuant to SFAS No. 123R.

***Income Taxes***

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

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

As of January 1, 2007, the date of adoption of FIN 48, the Company had \$1,200 of liabilities for unrecognized tax benefits. The amount of liability for unrecognized tax benefits that, if recognized, would decrease the Company's provision for income taxes and increase net income is \$1,000, net of the federal benefit for state taxes. There was no significant cumulative impact to retained earnings as a result of the adoption of FIN 48. The total liability for unrecognized tax benefits and the increase in the current period relate to reserves against the Company's research and development tax credits claimed on Federal and California returns.

Subsequent to adoption and during the period ended June 30, 2007, the Company revised its reserve estimate related to research and development tax credits as a result of the conclusion of the California audit for the 2003 tax year. This change in estimate resulted in a decrease in liabilities for unrecognized tax benefits from \$1,200 to \$497. The amount of liability for unrecognized tax benefits that, if recognized, would decrease the Company's provision of income taxes and increase net income is \$448, net of the federal benefit for state taxes. Recognition of liabilities for

unrecognized tax benefits would impact the Company's effective tax rate. As of June 30, 2007, the Company anticipates an additional increase to the liability for unrecognized tax benefits for fiscal 2007 in the amount of \$266.

The Company recognizes interest and /or penalties related to uncertain tax positions in income tax expense. To the extent accrued interest and penalties do not ultimately become payable, amounts accrued will be reduced and reflected as a reduction of the overall income tax provision in the period that such determination is made. The amount of interest and penalties accrued upon adoption of FIN 48 and at June 30, 2007 was \$0.

As of June 30, 2007, the Company is subject to taxation in the United States, California, North Carolina, New Jersey, and New York. The Company is subject to examination for tax years including and after 2003 for the United States, 2004 for California, and 2007 for the remaining jurisdictions. During the three months ended June 30, 2007, the Company favorably resolved an examination by California for the 2003 tax year, resulting in a decrease in the liability for unrecognized tax benefits of approximately \$96.

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**SHUTTERFLY, INC.**  
**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(In thousands, except per share amounts and percentages)**

***Comprehensive Income (Loss)***

Comprehensive income (loss) consists of certain changes in equity that are excluded from net income (loss). Specifically, unrealized gains and losses on marketable securities are included in accumulated other comprehensive income (loss). Accumulated other comprehensive loss was \$18 and \$35 at June 30, 2007 and December 31, 2006, respectively, resulting from unrealized gains and losses on marketable securities. Marketable securities are included as a component of cash and cash equivalents. Total comprehensive loss for the three and six months ended June 30, 2007 were \$2,430 and \$3,482, respectively.

***Recent Accounting Pronouncements***

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements ( SFAS 157 ). SFAS 157 defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. SFAS 157 will be effective for the Company as of January 1, 2008. The Company is currently evaluating the impact, if any, of adopting SFAS 157 on its consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities ( SFAS 159 ), which permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. SFAS 159 will be effective for the Company as of January 1, 2008. The Company is currently evaluating the impact, if any, of adopting SFAS 159 on its financial position and results of operations.

**Note 2 Stock-Based Compensation**

***1999 Stock Plan***

In September 1999, the Company adopted the 1999 Stock Plan (the 1999 Plan ). Under the Plan, the Company issued shares of common stock and options to purchase common stock to employees, directors and consultants. Options granted under the 1999 Plan were incentive stock options or non-qualified stock options. Incentive stock options ( ISOs ) were granted only to Company employees, which includes officers and directors who were also employees of the Company. Non-qualified stock options ( NSOs ) and stock purchase rights could be granted to employees, non-employee directors and consultants. Options under the 1999 Plan were to be granted at prices not less than 85% of the fair market value of the shares on the date of the grant as determined by the Company's Board of Directors ( the Board ), provided, however, that (i) the exercise price of an ISO was not less than 100% of the fair market value of the shares on the date of grant, and (ii) the exercise price of an ISO or NSO granted to a stockholder who owned greater than 10% of the voting power of all classes of stock was not less than 110% of the deemed fair value of the shares on the date of grant. The Board determined the period over which options become exercisable and vested. The term of the options was to be no longer than five years for ISOs to grantees who own greater than 10% of the voting power of all classes of stock; and no longer than ten years for all other options. Options granted under the 1999 Plan were exercisable in full as of the grant date, and generally vested over four years. The Board of Directors determined that no further grants of awards under the 1999 Plan would be made after the Company's IPO.

***2006 Equity Incentive Plan***

In June 2006, the Board adopted, and in September 2006 the Company's stockholders approved, the 2006 Equity Incentive Plan (the 2006 Plan ), and all shares of common stock available for grant under the 1999 Plan transferred to the 2006 Plan. The 2006 Plan provides for the grant of ISOs to employees (including officers and directors who are also employees) of the Company or of a parent or subsidiary of the Company, and for the grant of all other types of awards to employees, officers, directors, consultants, independent contractors and advisors of the Company or any parent or subsidiary of the Company, provided such consultants, independent contractors and advisors render bona-fide services not in connection with the offer and sale of securities in a capital-raising transaction. Other types of awards under the 2006 Plan include NSOs, restricted stock awards, stock bonus awards, stock appreciation rights, restricted stock units, and performance shares.

Options granted under the 2006 Plan have terms not to exceed 10 years, and they are issued with an exercise price equal to the fair market value of the shares of common stock on the date of grant as determined by the Board;

provided, however, that (i) the term of

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an option may be no longer than five years for ISOs to grantees who own greater than 10% of the voting power of all classes of stock; and (ii) the exercise price of an ISO granted to a stockholder who owns greater than 10% of the voting power of all classes of stock must be not less than 110% of the fair market value of the shares on the date of grant. Following the IPO, the fair market value of the Company's common stock is determined as the last sale price of such stock on the Nasdaq Global Market on the date of the grant. Options issued under the 2006 Plan typically vest and become exercisable with respect to 25% of the shares one year after the options' vesting commencement date, and the remainder ratably on a monthly basis over the following three years.

At the time of adoption, there were 1,358 shares of common stock authorized for issuance under the 2006 Plan plus 93 shares of common stock from the 1999 Plan that were unissued. The 2006 Plan provides for automatic replenishments of shares on January 1 of 2008, 2009 and 2010, of the lesser of (i) 4.62% of our shares outstanding on the December 31 immediately prior to the date of increase or (ii) a lesser number as determined by the Board.

***Stock Option Activity***

A summary of the Company's stock option activity for the six months ended June 30, 2007 is as follows:

|  | <b>Shares<br/>Available<br/>for<br/>Grant</b> | <b>Number<br/>of<br/>Options<br/>Outstanding</b> | <b>Weighted<br/>Average<br/>Exercise<br/>Price</b> | <b>Weighted<br/>Average<br/>Contractual<br/>Term<br/>(Years)</b> | <b>Aggregate<br/>Intrinsic<br/>Value</b> |
|--|---|--|--|--|--|
| Balances, December 31, 2006                          | 1,378   | 5,034  | \$ 7.28  |  |  |
| Granted  | (706)   | 706  | 16.41  |  |  |
| Exercised  |   | (270)  | 0.65   |  |  |
| Forfeited, cancelled or expired                      | 70  | (70)   | 8.29   |  |  |
| Balances, March 31, 2007                             | 742   | 5,400  | \$ 8.79  | 8.5  | \$ 39,486                                |
| Granted  | (423)   | 423  | 18.23  |  |  |
| Exercised  |   | (306)  | 5.15   |  |  |
| Forfeited, cancelled or expired                      | 160   | (160)  | 7.76   |  |  |
| Balances, June 30, 2007                              | 479   | 5,357  | 9.77   | 8.3  | 63,125                                   |
| Options vested and expected to vest at June 30, 2007 |   | 5,045  | 9.60   | 8.3  | 60,314                                   |
| Options vested at June 30, 2007                      |   | 1,767  | 6.27   | 7.6  | 26,988                                   |

During the three months ended June 30, 2007, the Company granted stock options to purchase an aggregate of 423 shares of common stock with an estimated weighted-average grant-date fair value of \$7.22 per share. The total fair value of options that vested during the three months ended June 30, 2007 was \$1,960. The total intrinsic value of options exercised during the three months ended June 30, 2007 was \$4,169. Net cash proceeds from the exercise of stock options were \$1,573 for the three months ended June 30, 2007. As permitted by SFAS No. 123R, the Company has deferred the recognition of its excess tax benefit from non-qualified stock option exercises.

***Stock-based Compensation***

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

options granted during the three months ended June 30, 2007 were as follows:

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**SHUTTERFLY, INC.**  
**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
(In thousands, except per share amounts and percentages)

|                                 | <b>Three<br/>Months<br/>Ended<br/>June 30, 2007<br/>(Unaudited)</b> |
|---------------------------------|---|
| Dividend yield                  |   |
| Annual risk free rate of return | 4.9%  |
| Expected volatility             | 40.9%   |
| Expected term (years)           | 4.2   |

Employee stock-based compensation expense recognized in the six months ended June 30, 2007 was calculated based on awards ultimately expected to vest and has been reduced for estimated forfeitures. SFAS No. 123R requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

At June 30, 2007, the Company had \$13,821 of total unrecognized compensation expense under SFAS No. 123R, net of estimated forfeitures, related to stock option plans that will be recognized over a weighted-average period of approximately three years.

**Note 3 Net Loss Per Share**

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

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

|   | Three Months<br>Ended June 30, |            | Six Months<br>Ended June 30, |            |
|---|--------------------------------|------------|------------------------------|------------|
|   | 2007                           | 2006       | 2007                         | 2006       |
| <b>Historical net loss per share:</b>                               |                                |            |                              |            |
| Numerator   |                                |            |                              |            |
| Net loss  | \$ (2,439)                     | \$ (2,093) | \$ (3,500)                   | \$ (3,658) |
| Denominator   |                                |            |                              |            |
| Weighted-average common shares outstanding                          | 24,151                         | 4,016      | 24,054                       | 4,016      |
| Less: Weighted-average unvested common shares subject to repurchase | (15)                           | (131)      | (20)                         | (158)      |
| Denominator for basic net loss per share                            | 24,136                         | 3,885      | 24,034                       | 3,858      |
| Dilutive effect of stock options and shares subject to repurchase   |                                |            |                              |            |
| Denominator for diluted net loss per share                          | 24,136                         | 3,885      | 24,034                       | 3,858      |
| Net loss per share basic and diluted                                | \$ (0.10)                      | \$ (0.54)  | \$ (0.15)                    | \$ (0.95)  |



**Table of Contents****SHUTTERFLY, INC.****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****(In thousands, except per share amounts and percentages)**

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

|   | <b>Three Months<br/>Ended June 30,</b> |             | <b>Six Months<br/>Ended June 30,</b> |             |
|---|--|-------------|--------------------------------------|-------------|
|   | <b>2007</b>                            | <b>2006</b> | <b>2007</b>                          | <b>2006</b> |
| Options to purchase common stock and common stock subject to repurchase | 1,775                                  | 1,888       | 1,730                                | 1,888       |
| Warrants to purchase common stock                                       | 24                                     |             | 24                                   |             |
| Convertible preferred stock (as converted basis)                        |  | 13,802      |                                      | 13,802      |
| Convertible preferred stock warrants (as converted basis)               |  | 59          |                                      | 58          |

**Note 4 Balance Sheet Components*****Inventories***

Inventories are primarily raw materials and consist principally of paper, photo book covers, and packaging supplies.

***Property and Equipment***

|   | <b>June 30,<br/>2007</b> | <b>December<br/>31,<br/>2006</b> |
|---|--------------------------|----------------------------------|
| Computer and other equipment                    | \$ 53,211                | \$ 41,880                        |
| Software  | 11,174                   | 8,791                            |
| Leasehold improvements                          | 6,508                    | 4,903                            |
| Furniture and fixtures                          | 1,868                    | 1,348                            |
|   | 72,761                   | 56,922                           |
| Less: Accumulated depreciation and amortization | (33,175)                 | (26,003)                         |
| Net property and equipment                      | \$ 39,586                | \$ 30,919                        |

Property and equipment includes \$6,547 and \$6,502 of equipment under capital leases at June 30, 2007 and December 31, 2006, respectively. Accumulated depreciation of assets under capital leases totaled \$4,596 and \$3,820 at June 30, 2007 and December 31, 2006, respectively.

Depreciation and amortization expense totaled \$3,984 and \$2,379 for the three months ended June 30, 2007 and 2006, respectively. Depreciation and amortization expense totaled \$7,468 and \$4,556 for the six months ended June 30, 2007 and 2006, respectively.

***Accrued Liabilities***

|                            | <b>June 30,<br/>2007</b> | <b>December<br/>31,<br/>2006</b> |
|----------------------------|--------------------------|----------------------------------|
| Accrued marketing expenses | \$ 1,947                 | \$ 1,822                         |
| Accrued compensation       | 1,833                    | 1,201                            |
| Accrued purchases          | 1,005                    | 483                              |

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|                             |           |          |
|-----------------------------|-----------|----------|
| Accrued taxes               | 886       | 1,235    |
| Accrued consultant expenses | 1,156     | 884      |
| Accrued other               | 6,267     | 3,183    |
|                             | \$ 13,094 | \$ 8,808 |

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**SHUTTERFLY, INC.**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(In thousands, except per share amounts and percentages)**

**Note 5 Commitments and Contingencies**

***Indemnifications***

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

***Contingencies***

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

***Legal Matters***

On June 19, 2007, FotoMedia Technologies, LLC filed a lawsuit in the Eastern District of Texas against Shutterfly, America Online, Inc., Photobucket.com, Inc., CNET Networks, Inc. and Yahoo! Inc., alleging that the defendants infringe three U.S. patents (U.S. Patent No. 6,018,774, No. 6,542,936 and No. 6,871,231). The plaintiff is seeking treble damages, attorneys' fees, and an injunction against all parties, including the Company, based on unspecified allegations of infringement of the three patents listed above. The Company has been served with the complaint, and its response is currently due August 24, 2007. The Company disputes the plaintiff's claims and believes that it has meritorious defenses and intends to vigorously defend this action. At this time, the Company does not believe that the amount of potential loss, if any, is reasonably estimable.

On August 29, 2006, our former Chief Financial Officer, Virender Ahluwalia, sued the Company in San Mateo County Superior Court alleging causes of action for reformation of contract, breach of contract and breach of fiduciary duty. The plaintiff claims that he is entitled to exercise stock options for an additional 16 shares of the Company's common stock because his vesting schedule should be deemed to have started one year earlier than the date stated in the Company's corporate records. In addition, plaintiff claims that the Company initially did not advise him that withholding taxes were due at the time of exercise of his nonqualified stock options to purchase 277 shares of common stock in 2005, but that the Company later modified that tax advice, extended his option exercise date, and required that he make provision for the applicable withholding taxes at the time of exercise of such options. The plaintiff claims he was damaged by having to immediately sell a portion of those shares upon his exercise in order to raise the funds necessary to pay applicable withholding taxes. He also claims that the calculation of the fair market value of the shares for the purpose of calculating his tax liability was improper. The plaintiff is seeking compensatory and punitive damages. In October 2006, the Company filed a Petition to Compel Arbitration and to stay the litigation pending arbitration, and the plaintiff has now stipulated to arbitration of the dispute. The parties have engaged in discovery in the Arbitration and the Company has recently moved for summary judgment on the claims, which the plaintiff has opposed. The Company disputes the plaintiff's claims, believes that it has meritorious defenses and intends to vigorously defend this action. At this time, the Company does not believe that the amount of potential loss, if any, is reasonably estimable.

From time to time, the Company may be involved in various legal proceedings arising in the ordinary course of business. At June 30, 2007, in the opinion of management, there are no other matters that are expected to have a material adverse effect on the Company's financial position, results of operations or cash flows.

**Table of Contents****ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.****CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS**

*This document, including the following Management's Discussion and Analysis of Financial Condition and Results of Operations, contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934 that are based upon our current expectations. These forward-looking statements include statements related to our expectations regarding the seasonality of our business, revenue trends, operating expenses as a percentage of net revenues, the decline in average selling prices for prints, our capital expenditures for 2007, effective tax rates, realization of deferred tax assets, the sufficiency of our cash and cash equivalents balances and cash generated from operations for the next 12 months and our ability to grow our personalized products and services as a percentage of our total revenues, as well as other statements regarding our future operations, financial condition and prospects and business strategies. In some cases, you can identify forward-looking statements by terminology such as project, believe, anticipate, plan, expect, estimate, intend, continue, should, would, could, potentially, will, or may, or the negative of these terms or other comparable terminology. Forward-looking statements involve risks and uncertainties. Our actual results and the timing of events could differ materially from those anticipated in our forward-looking statements as a result of many factors, including but not limited to, the seasonality of our business, whether we are able to expand our customer base and increase our product and service offering, competition in our marketplace and the other risks set forth below under Risk Factors in Part II, Item 1A of this report. Given these risks and uncertainties, readers are cautioned not to place undue reliance on such forward-looking statements. We assume no obligation to update any of the forward-looking statements after the date of this report or to conform these forward-looking statements to actual results.*

**Overview**

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

We currently generate revenues by selling photo-based products such as greeting cards, personalized calendars, professionally-bound photo books, and high-quality prints, ranging in size from wallet- to jumbo-sized 20x30 enlargements. We currently manufacture all of these items in our Hayward, California manufacturing facility. We will also manufacture these items in a new facility in Charlotte, North Carolina which is planned to be fully operational by the fourth quarter of 2007. By controlling the production process in these facilities, we are able to manufacture high-quality products, maintain a favorable cost structure and provide timely shipments to customers, even during peak demand. Additionally, we sell a variety of photo-based merchandise that is currently manufactured for us by third parties, such as mugs, mouse pads, coasters, tote bags, desk organizers, puzzles, playing cards, multi-media DVDs, magnets and keepsake boxes, and ancillary products, such as frames, photo albums and scrapbooking accessories.

In the past two years, we have launched numerous new products, including canvas prints, keepsake boxes, posters, jewelry, desk organizers, multi-media DVD slideshows, magnets, coasters, year-at-a-glance calendars, tiled mugs, playing cards, puzzles, scrapbooking supplies and frames, as well as numerous enhancements to our photo books, including new square-book formats (the 12 x 12 Memory Book, the 8 x 8 Story Book, and the 4 x 4 Brag Book), new photo book covers, layouts, page designs, and licensed content for children's character-themed photo books including Sesame Street<sup>(R)</sup>, Clifford the Big Red Dog<sup>(R)</sup>, Angelina Ballerina<sup>(R)</sup>, and Thomas the Tank Engine<sup>(R)</sup>. In addition to new products, we have created new services, including: the ability to search, tag and organize photos; the launch of Shutterfly Studio, our consumer desktop software application that allows for uploading, organizing, printing, sharing and editing from the desktop; a redesigned and easier to use website; a new store that makes shopping easier and more accessible; and dozens of new borders that customers can use to enhance their pictures, cards and photo books. To help facilitate the photo book creation process, we have organized design choices into popular occasions such as

Wedding, Travel, Birthday, Baby, Kids, Class Year Book, Recipe Book, Portfolio and Journal. Within each occasion, we have created more than 70 pre-set style templates that include fonts, photo edges, page layouts and backgrounds.

In addition, during the second quarter of fiscal year 2007, we entered into a strategic merchandising arrangement with Target Corporation ( Target ). Under the terms of the agreement, Target customers will be able to upload and organize their photos online and access our services to store, share and print their digital photos, and create photo-based products. Additionally, our customers will be able to order prints for pick-up at local Target stores.

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During the second quarter, we also completed the acquisition of certain assets and certain liabilities of CustomAbility, LLC, a publishing company that produces customized children's books under the brand name Make It About Me! ( MIAM ). The total consideration paid, assets acquired, and liabilities assumed in this transaction were immaterial. MIAM produced the Sesame Street® book, My Adventure on Sesame Street and My Amazing Alphabet Adventures. Now available on Shutterfly, these adventure books integrate a picture into the book's illustrations and storyline. This acquisition augments our personal publishing platform with popular Sesame Street children characters and content.

We have experienced rapid growth since launching our service in December 1999. Since inception through June 2007 we have fulfilled more than 17.3 million orders, sold more than 545 million prints and stored approximately 1.6 billion of our consumers' photos in our image archives. According to industry sources, in 2006, Shutterfly.com had approximately 28.9 million unique visitors.

**Basis of Presentation**

*Net Revenues.* We generate revenues primarily from the printing and shipping of photo-based products, such as photo books, cards and calendars, photo prints, and photo-based merchandise, such as mugs, mouse pads and keepsake boxes, and ancillary products such as frames, photo albums and scrapbooking accessories. Revenues are recorded net of estimated returns, promotions redeemed by customers and other discounts. Customers place orders via our website and pay primarily using credit cards. Historically, most of our revenues have been derived in the United States. For the six months ended June 30, 2007, approximately 98% of our revenue came from customers with billing addresses in the United States.

Our personalized products and services revenues are derived from the sale of photo-based products, photo-based merchandise and ancillary products and services, and the related shipping revenues from these sales. We believe our personalized photo-based products differentiate us from other traditional photo processors and are key to attracting and retaining customers.

Our print revenues are derived from sales of our photo processing of digital images, including sales of 4x6 prints, and the related shipping revenues from these sales. Historically, average selling prices for prints have declined, and they may continue to decline in the future. For example, in the second quarter of 2005, a competitor reduced the list price of its 4x6 prints from \$0.19 to \$0.12. In response, we lowered the list price of our 4x6 prints from \$0.29 to \$0.19 in the fourth quarter of 2005. This decrease negatively affected our print revenues for the year ended December 31, 2006. List pricing for 4x6 prints has generally stabilized in the marketplace over the last year and a half since we reduced our pricing. Further drops in our 4x6 prices, due to competitive pricing pressure or otherwise, without corresponding increases in volumes would negatively impact our net revenues and could adversely affect our gross margins.

To offset these price declines and to improve profitability, we have continued to invest in large scale manufacturing technology to enable us to reduce the cost of manufacturing prints. We have also continued to recruit highly qualified personnel with specialized skills in print manufacturing. We believe that these strategies have allowed us, and will continue to allow us, to compete successfully with other companies in our industry. In addition, we continue to focus on diversifying our business towards the large and growing market for personalized products and services.

Our business is subject to seasonal fluctuations. In particular, we generate a substantial portion of our net revenues during the holiday season in the fourth quarter of the calendar year. During the fiscal year ended December 31, 2006, we generated 53% of our total revenue in the fourth quarter. We also typically experience increases in revenues during other shopping-related seasonal events, such as Valentine's Day, Mother's Day, Father's Day, Halloween and Easter. We generally experience lower net revenues during the first, second and third quarters. As is typical in the retail industry, we have incurred and may continue to incur losses in these quarters. Due to the relatively short lead time required to fulfill orders for our products, usually one to three business days, order backlog, WIP, and finished goods are not material to our business.

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

*Average Order Value.* Average order value is net revenues for a given period of time divided by the total number of customer orders recorded during that same period. We seek to increase average order value as a means of



increasing net revenues. Average order value has increased on an annual basis for each year since 2000, and we anticipate that this trend may continue in the future.

*Total Number of Orders.* We closely monitor total number of orders as an indicator of revenue trends. We recognize the revenues associated with an order when the products have been shipped and all other revenue recognition criteria have been met. This is

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consistent with our revenue recognition policy discussed in Critical Accounting Policies and Estimates below. Orders are typically processed and shipped within two business days after a customer places an order. Total number of orders has increased on an annual basis for each year since 2000, and we anticipate that this trend will continue in the future.

*Personalized Products and Services Revenues as Percentage of Net Revenues.* We continue to innovate and improve our personalized products and services and expect the net revenues from these products and services to increase as a percentage of net revenues.

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

*Cost of Revenues.* Cost of revenues consist primarily of direct materials (the majority of which consists of paper and photo book covers), payroll and related expenses for direct labor, shipping charges, packaging supplies, distribution and fulfillment activities, rent for production facilities, depreciation of production equipment and third-party costs for photo-based merchandise. Cost of revenues also includes payroll and related expenses for personnel engaged in customer service. In addition, cost of revenues includes any third-party software or patents licensed, as well as the amortization of capitalized website development costs. We capitalize eligible costs associated with software developed or obtained for internal use in accordance with the American Institute of Certified Public Accountants, or AICPA, Statement of Position No. 98-1, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use and Emerging Issues Task Force, or EITF, Issue No. 00-02, Accounting for Website Development Costs. Costs incurred in the development phase are capitalized and amortized in cost of revenues over the product's estimated useful life.

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

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

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

General and administrative expense includes general corporate costs, including rent for our corporate offices, insurance, depreciation on information technology equipment and legal and accounting fees. In addition, general and administrative expense includes personnel expenses of employees involved in executive, finance, accounting, human resources, information technology and legal roles. Third-party payment processor and credit card fees are also included in general and administrative expense and have historically fluctuated based on revenues for the period. We expect our general and administrative expense will increase in absolute dollars in the near to intermediate term as we will incur additional legal and accounting costs in order to comply with regulatory reporting requirements and the Sarbanes-Oxley Act of 2002, as well as additional costs such as investor relations and higher insurance premiums.

*Interest Expense.* Interest expense consists of interest costs recognized under our capital lease obligations and for borrowed money.

*Other Income (Expense), Net.* Other income (expense), net consists primarily of the interest income on our cash accounts and the changes in the fair value of our convertible preferred stock warrants under FASB Staff Position, or FSP 150-5, Issuer's Accounting under FASB Statement No. 150 for Freestanding Warrants and Other Similar Instruments on Shares That Are Redeemable adopted in July 2005. Under FSP 150-5, the warrants were subject to re-measurement at each balance sheet date, and changes in fair value were recognized as a component of other income

(expense), net. Subsequent to the completion of our initial public offering on October 4, 2006, all of our warrants to purchase shares of preferred stock converted into warrants to purchase shares of common stock. Accordingly, the liability for the convertible preferred stock warrants was reclassified as common stock and additional paid-in capital and the warrants are no longer subject to re-measurement.

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*Income Taxes.* Provision for income taxes depends on the statutory rate in the countries where we sell our products. Historically, we have only been subject to taxation in the United States because we have sold almost all of our products to customers in the United States. If we continue to sell our products primarily to customers located within the United States, we anticipate that our long-term future effective tax rate will be between 37% and 44%, without taking into account the use of any of our net operating loss carryforwards. However, we anticipate that in the future we may further expand our sale of products to customers located outside of the United States. In that case we would become subject to taxation based on the foreign statutory rates in the countries where these sales took place and our effective tax rate could fluctuate accordingly.

Our fiscal year end for federal and state tax purposes was September 30. During the period ended June 30, 2007, the taxing authorities granted our request to change our fiscal year end for tax purposes to December 31. We expect to file a short period income tax return for federal and state purposes covering October 1, 2006 through December 31, 2006. We do not expect this will have a material impact on our income tax provision. As of June 30, 2007, for federal and state tax purposes, we had approximately \$43 million of federal and \$41 million of state net operating loss carryforwards available to reduce future taxable income. These net operating loss carryforwards begin to expire in 2020 and 2008 for federal and state tax purposes, respectively.

**Critical Accounting Policies and Estimates**

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

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

*Revenue Recognition.* We generate revenues primarily from the printing and shipping of photo-based products, such as photo books, cards and calendars, photo prints, photo-based merchandise, such as mugs, mouse pads and magnets, and ancillary products such as frames, photo albums and scrapbooking accessories. We generally recognize revenues from product sales upon shipment when persuasive evidence of an arrangement exists (typically through the use of a credit card or receipt of a check), the selling price is fixed or determinable and collection of resulting receivables is reasonably assured. Revenues from amounts billed to customers, including prepaid orders, are deferred until shipment of fulfilled orders. The Company also generates revenue from order referral fees received from merchants for customer click-throughs and orders that are placed on the merchants' websites. Revenue generated from order referrals is recognized in the period that the click-through impression is delivered, provided that there is persuasive evidence of an arrangement, the fee is fixed or determinable, no significant obligations remain and collection is reasonably assured.

We provide our customers with a 100% satisfaction guarantee whereby products can be returned within a 30-day period for a reprint or refund. We maintain an allowance for estimated future returns based on historical data. Revenues are recorded net of estimated returns and the provision for estimated returns is included in accrued liabilities. During the three months ended June 30, 2007, returns totaled less than 1% of net revenues and have been within management's expectations. We periodically provide incentive offers to our customers in exchange for setting up an account and to encourage purchases. Such offers include free products and percentage discounts on current purchases. Discounts, when accepted by customers, are treated as a reduction to the purchase price of the related transaction and are reflected in net revenues. Production costs related to free products are included in costs of

revenues upon redemption. Shipping charged to customers is recognized as revenues.

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

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*Software and Website Development Costs.* We capitalize eligible costs associated with software developed or obtained for internal use in accordance with the AICPA Statement of Position No. 98-1 and EITF Issue No. 00-2. Accordingly, payroll and payroll-related costs incurred in the development phase are capitalized and amortized over the product's estimated useful life, which is generally three years. Costs associated with minor enhancements and maintenance for our website are expensed as incurred.

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

Effective January 1, 2007, we account for uncertain tax positions in accordance with FASB Interpretation No. 48 Accounting for Uncertainty in Income Taxes (FIN 48) an interpretation of FASB Statement No. 109 (SFAS 109). The application of income tax law is inherently complex. Laws and regulations in this area are voluminous and are often ambiguous. As such, we are required to make many subjective assumptions and judgments regarding our income tax exposures. Interpretations and guidance surrounding income tax laws and regulations change over time. As such, changes in our subjective assumptions and judgments can materially affect amounts recognized in the consolidated balance sheets and statements of income.

*Stock-based Compensation Expense.* Effective January 1, 2006, we adopted the fair value recognition provisions of SFAS No. 123R, Share-Based Payment, using the prospective transition method, which requires us to apply the provisions of SFAS No. 123R only to new awards granted, and to awards modified, repurchased or cancelled, after the effective date. Under this transition method, stock-based compensation expense recognized beginning January 1, 2006 is based on the following: (a) the grant-date fair value of stock option awards granted or modified after January 1, 2006; and (b) the balance of deferred stock-based compensation related to stock option awards granted prior to January 1, 2006, which was calculated using the intrinsic value method as previously permitted under APB Opinion No. 25.

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

**Table of Contents****Results of Operations**

|                             | <b>Three Months<br/>Ended June 30,</b> |             | <b>Six Months<br/>Ended June 30,</b> |             |
|-----------------------------|--|-------------|--------------------------------------|-------------|
|                             | <b>2007</b>                            | <b>2006</b> | <b>2007</b>                          | <b>2006</b> |
| Net revenues                | 100%                                   | 100%        | 100%                                 | 100%        |
| Cost of revenues            | 50%                                    | 50%         | 49%                                  | 51%         |
| Gross profit                | 50%                                    | 50%         | 51%                                  | 49%         |
| Operating expenses:         |  |             |                                      |             |
| Technology and development  | 22%                                    | 22%         | 22%                                  | 23%         |
| Sales and marketing         | 24%                                    | 23%         | 22%                                  | 22%         |
| General and administrative  | 23%                                    | 22%         | 22%                                  | 21%         |
| Loss from operations        | (19)%                                  | (17)%       | (15)%                                | (17)%       |
| Interest expense            | 0%                                     | 0%          | 0%                                   | 0%          |
| Other income (expense), net | 5%                                     | 0%          | 5%                                   | 1%          |
| Loss before income taxes    | (14)%                                  | (17)%       | (10)%                                | (16)%       |
| Benefit from income taxes   | 6%                                     | 6%          | 4%                                   | 6%          |
| Net loss                    | (8)%                                   | (11)%       | (6)%                                 | (10)%       |

**Comparison of the Three and Six Month Periods Ended June 30, 2007 and 2006**

|                  | <b>Three Months Ended June<br/>30,</b> |             |                     | <b>Six Months Ended June<br/>30,</b> |             |                     |
|------------------|--|-------------|---------------------|--------------------------------------|-------------|---------------------|
|                  | <b>2007</b>                            | <b>2006</b> | <b>%<br/>Change</b> | <b>2007</b>                          | <b>2006</b> | <b>%<br/>Change</b> |
|                  | <b>(in thousands)</b>                  |             |                     | <b>(in thousands)</b>                |             |                     |
| Net revenues     | \$29,877                               | \$19,637    | 52%                 | \$56,582                             | \$36,520    | 55%                 |
| Cost of revenues | 14,832                                 | 9,756       | 52%                 | 27,866                               | 18,505      | 51%                 |

Net revenues increased \$10.2 million, or 52%, for the three months ended June 30, 2007 as compared to the same period in 2006. Net revenues increased \$20.1 million, or 55% for the six months ended June 30, 2007 as compared to the same period in 2006. Revenue growth was attributable to the increases in both personalized product and services and print revenues. Personalized products and services revenues increased \$7.3 million, or 88%, to \$15.6 million for the three months ended June 30, 2007 as compared to the same period in 2006. Personalized products and services revenues increased \$14.0 million, or 95%, to \$28.7 million for the six months ended June 30, 2007 as compared to the same period in 2006. Personalized products and services revenues were positively affected by increased sales of photo books, calendars, folded greeting cards and photo-based merchandise. This caused personalized products and services revenues to increase to 52% and 51% of revenues from 42% and 40% in the three and six month periods ended June 30, 2007 compared to the same periods in 2006, respectively. Print revenues increased \$2.9 million, or 26%, to \$14.2 million for the three months ended June 30, 2007 as compared to the same period in 2006. Print revenues increased \$6.1 million, or 28%, to \$27.8 million for the six months ended June 30, 2007 as compared to the same period in 2006. Print revenues were positively affected by increased sales volumes of 4x6 and 4x8 prints. Total number of orders increased 40% and 36% to 1,462,000 and 2,750,000 for the three and six months ended June 30, 2007, respectively, as compared to the same periods in 2006. Average order value increased 8% and 14% to \$20.44 and \$20.57 per order for the three and six months ended June 30, 2007, respectively, as compared to the same periods in 2006, a result of the increased sales of photo books which have higher prices.

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Cost of revenues increased \$5.1 million, or 52%, for the three months ended June 30, 2007 as compared to the same period in 2006. Cost of revenues increased \$9.4 million, or 51%, for the six months ended June 30, 2007 as compared to the same period in 2006. The cost of revenues increase was driven by the increased volume of shipped products. Cost of revenues as a percentage of net revenues remained flat and decreased by 2% for the three and six months ended June 30, 2007, respectively, as compared to the same period in 2006. The three and six month changes in cost of revenues, year over year, were the result of several efforts to increase operational efficiencies. We anticipate that our cost of revenues will increase for the remainder of 2007 as we grow our business.

|                                    | Three Months Ended<br>June 30, |          |             | Six Months Ended June<br>30, |          |             |
|------------------------------------|--------------------------------|----------|-------------|------------------------------|----------|-------------|
|                                    | 2007                           | 2006     | %<br>Change | 2007                         | 2006     | %<br>Change |
|                                    | (in thousands)                 |          |             | (in thousands)               |          |             |
| Technology and development expense | \$ 6,641                       | \$ 4,271 | 56%         | \$ 12,455                    | \$ 8,254 | 51%         |
| Sales and marketing expense        | 7,199                          | 4,504    | 60%         | 12,379                       | 8,197    | 51%         |
| General and administrative expense | 6,741                          | 4,301    | 57%         | 12,705                       | 7,698    | 65%         |

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Our technology and development expense increased \$2.4 million, or 56%, for the three months ended June 30, 2007 as compared to the same period in 2006, although this expense remained flat as a percentage of net revenues at 22%. For the six months ended June 30, 2007, technology and development expense increased \$4.2 million, or 51%, as compared to the same period in 2006, although this expense decreased as a percentage of net revenues from 23% to 22%. These absolute increases were attributable to increased personnel and related costs for employees and consultants involved with website development and website infrastructure support teams, which increased by \$1.0 million and \$1.8 million for the three and six month periods, as well as third-party hosting expenses which remained flat and increased by \$0.2 million for the three and six month periods, respectively. We also continued to invest in our website infrastructure hardware to support our continued revenue growth, which resulted in increased depreciation expense of \$0.8 million and \$1.3 million in the three and six month periods. In addition, stock-based compensation expense from employee grants was \$0.2 million and \$0.5 million in the three and six months ended June 30, 2007, compared to \$0.1 million and \$0.3 million in the three and six months ended June 30, 2006. We anticipate that our technology and development expense will increase for the remainder of 2007 as we grow our business.

Our sales and marketing expense increased \$2.7 million, or 60%, for the three months ended June 30, 2007 as compared to the same period in 2006. This expense increased as a percentage of net revenues from 23% to 24%. For the six months ended June 30, 2007, sales and marketing expense increased \$4.2 million, or 51%, as compared to the same period in 2006. This expense remained flat as a percentage of net revenues at 22%. Personnel and related costs for employees and consultants increased by \$0.5 million and \$1.0 million in the three and six month periods, respectively, and our expenditures incurred on customer acquisition and promotion costs increased by \$2.1 million and \$2.9 million in the three and six month periods. In addition, stock-based compensation expense from employee grants was \$0.1 million and \$0.3 million in the three and six months ended June 30, 2007, compared to \$0.1 million and \$0.2 million in the three and six months ended June 30, 2006. We anticipate that our sales and marketing expense will increase for the remainder of 2007 as we grow our business.

Our general and administrative expense increased \$2.4 million, or 57%, for the three months ended June 30, 2007 as compared to the same period in 2006. This expense increased as a percentage of net revenues from 22% to 23%. For the six months ended June 30, 2007, general and administrative expense increased \$5.0 million, or 65%, as compared to the same period in 2006. This expense increased as a percentage of net revenues from 21% to 22%. Personnel and related costs for employees increased by \$0.5 million and \$1.1 million for the three and six months ended June 30, 2007 as compared to the same period in 2006. Legal and accounting fees decreased by \$0.1 million and increased by \$0.5 million, respectively for the three and six months ended June 30, 2007 as compared to the same period in 2006. Consulting expenses increased by \$0.6 million and \$1.1 million for the three and six months ended June 30, 2007 as compared to the same period in 2006, as a result of costs incurred primarily for Sarbanes-Oxley compliance efforts. Payment processing fees paid to third parties increased by \$0.3 million and \$0.5 million during the three and six months ended June 30, 2007 as compared to the same period in 2006 due to increased order volumes. In addition, stock-based compensation expense from employee grants was \$0.6 million and \$0.9 million in the three and six months ended June 30, 2007, compared to \$0.2 million and \$0.4 million in the three and six months ended June 30, 2006. We anticipate that our general and administrative expense will increase for the remainder of 2007 in order to support our growing operations.

Interest expense decreased by \$31,000 or 44% and \$55,000, or 37% for the three and six months ended June 30, 2007, respectively, as compared to the same periods in 2006, due primarily to a decrease in interest expense on capitalized lease obligations. We anticipate that interest expense will remain consistent for the remainder of 2007.

Other income (expense), net increased by \$1.4 million and \$2.4 million for the three and six months ended June 30, 2007 as compared to the same periods in 2006, due to larger invested cash balances and higher interest rates. For the three and six month periods in 2006, other income (expense), net also included \$249,000 and \$127,000 of income related to changes in the fair value of our redeemable convertible preferred stock warrants under FSP 150-5. Upon the completion of our initial public offering on October 4, 2006, all of our warrants to purchase shares of preferred stock converted into warrants to purchase shares of common stock and accordingly, no additional amounts for the change in fair value for the warrants will be recorded. We anticipate that other income (expense) will increase relative to the

prior year, for the remainder of 2007 due to our higher invested balances from cash proceeds from our IPO.

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|                    | <b>Three Months Ended June<br/>30,</b> |             | <b>Six Months Ended June<br/>30,</b> |             |
|--------------------|--|-------------|--------------------------------------|-------------|
|                    | <b>2007</b>                            | <b>2006</b> | <b>2007</b>                          | <b>2006</b> |
| Income tax benefit | \$ 1,721                               | \$ 1,123    | \$ 2,514                             | \$ 2,100    |
| Effective tax rate | 41%                                    | 35%         | 42%                                  | 36%         |

The benefit for income taxes was \$1.7 million and \$2.5 million for the three and six months ended June 30, 2007, compared to benefits of \$1.1 million and \$2.1 million for the same periods in 2006. The increases in tax benefits is due to increases in loss before income taxes, and changes in our effective tax rate, primarily due to the non-deductibility of stock-based compensation. We anticipate that our long term future effective tax rate will be between 37% and 44%, without taking into account the use of any of our net operating loss carry forwards.

|                          | <b>Three Months Ended June<br/>30,</b> |             |                     | <b>Six Months Ended June<br/>30,</b> |             |                     |
|--------------------------|--|-------------|---------------------|--------------------------------------|-------------|---------------------|
|                          | <b>2007</b>                            | <b>2006</b> | <b>%<br/>Change</b> | <b>2007</b>                          | <b>2006</b> | <b>%<br/>Change</b> |
|                          | <b>(in thousands)</b>                  |             |                     | <b>(in thousands)</b>                |             |                     |
| Loss before income taxes | \$ (4,160)                             | \$ (3,216)  | 29%                 | \$ (6,014)                           | \$ (5,758)  | 4%                  |
| Net loss                 | (2,439)                                | (2,093)     | 17%                 | (3,500)                              | (3,658)     | 4%                  |

Net loss increased by \$0.3 million, or 17% and decreased by \$0.2 million, or 4%, for the three and six months ended June 30, 2007 as compared to the same period in 2006.

Table of Contents**Liquidity and Capital Resources**

|   | <b>Six Months Ended June 30,</b> |             |
|---|----------------------------------|-------------|
|   | <b>2007</b>                      | <b>2006</b> |
|   | <b>(in thousands)</b>            |             |
| <b>Consolidated Statements of Cash Flows Data:</b>    |                                  |             |
| Capital expenditures                                  | \$ 16,069                        | \$ 6,341    |
| Depreciation and amortization                         | 7,545                            | 4,714       |
| Cash flows provided by (used in) operating activities | 2,212                            | (8,096)     |
| Cash flows used in investing activities               | (17,701)                         | (6,341)     |
| Cash flows provided by (used in) financing activities | 449                              | (749)       |

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

Historically we have financed our operations and capital expenditures through operations, private sales of preferred stock, our initial public offering, lease financing and the use of bank and related-party loans. As a result of our initial public offering in September 2006, we raised approximately \$80.9 million of proceeds, net of underwriters' discount, which we received on October 4, 2006. At June 30, 2007, we had \$104.0 million of cash and cash equivalents, a decrease from \$119.1 million as of December 31, 2006. Cash equivalents are comprised of money market funds and investment-grade corporate bonds.

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

We anticipate capital expenditures of \$12 million to \$15 million for the remainder of 2007, a portion of which we expect will be used to add manufacturing capacity. These expansion plans, while significant, are not outside the ordinary course of our business or materially different from how we have expanded our business in the past. We expect that such capital expenditures will increase our production capacity and help enable us to respond more quickly and efficiently to customer demand. We believe that such capital expenditures will have a positive effect on our results of operations if demand increases in line with increases in our production capacity. However, these capital expenditures will have a negative effect on our results of operations if demand does not increase as we expect, and will have a negative effect on our results of operations in the short term if demand does not increase simultaneously, as we expect, with the capital expenditures spent to support increased demand.

*Operating Activities.* For the six months ended June 30, 2007, net cash provided by operating activities was \$2.2 million, primarily due to our net loss of \$3.5 million and the net change in operating assets and liabilities of \$0.7 million, adjusted for non-cash items including \$7.5 million of depreciation and amortization expense, \$2.9 million benefit for income taxes and \$1.8 million of stock-based compensation.

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For the six months ended June 30, 2006, net cash used in operating activities of \$8.1 million resulted from our net loss of \$3.7 million and the net change in operating assets and liabilities of \$8.1 million, adjusted for non-cash items including \$4.7 million of depreciation and amortization expense, \$2.1 million of benefit for income taxes, \$0.9 million of amortization of stock-based compensation and \$0.1 million of change in carrying value of preferred stock warrant liability.

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*Investing Activities.* For the six months ended June 30, 2007, net cash used in investing activities was \$17.7 million primarily for capital expenditures for computer and network hardware to support our website infrastructure and information technology computer hardware and capitalized website development costs related to projects that were placed into service and acquisition costs. Subsequent to June 30, 2007, we entered into an unsecured loan commitment to provide interim financing to an unrelated third party for up to \$1 million.

For the six months ended June 30, 2006, net cash used in investing activities was \$6.3 million for capital expenditures for computer and network hardware to support our website infrastructure and information technology computer hardware and capitalized website development costs related to projects that were placed into service.

*Financing Activities.* Our financing activities for the six months ended June 30, 2007 provided cash of \$0.5 million, primarily from \$1.8 million of proceeds from issuance of common stock less cash used of \$1.3 million of principal payments on capital lease obligations.

For the six months ended June 30, 2006, net cash used in financing activities was \$0.7 million, primarily from principal payments on capital lease obligations.

### **Off-Balance Sheet Arrangements**

We do not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. We do not have any undisclosed borrowings or debt, and we have not entered into any synthetic leases. We are, therefore, not materially exposed to any financing, liquidity, market or credit risk that could arise if we had engaged in such relationships. As part of the acquisition of MIAM, we agreed to make additional earnout payments of up to \$0.6 million if certain milestones are achieved over the next 18 months.

### **Recent Accounting Pronouncements**

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements ( SFAS 157 ). SFAS 157 defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. SFAS 157 is effective for us as of January 1, 2008. We are currently evaluating the impact, if any, of SFAS 157 on its consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities ( SFAS 159 ) which permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. SFAS 159 will be effective for us as of January 1, 2008. We are currently evaluating the impact, if any, of adopting SFAS 159 on its financial position and results of operations.

## **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

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

As of June 30, 2007 and December 31, 2006, our cash and cash equivalents were maintained by financial institutions in the United States and our deposits may be in excess of insured limits. We believe that the financial institutions that hold our investments are financially sound and, accordingly, minimal credit risk exists with respect to these investments.

*Inflation.* We do not believe that inflation has had a material effect on our current business, financial condition or results of operations. If our costs were to become subject to significant inflationary pressures, we may not be able to fully offset such higher costs through price increases. Our inability or failure to do so could harm our business, financial condition and results of operations.

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### **ITEM 4. CONTROLS AND PROCEDURES**

Our management, with the participation of our chief executive officer and chief financial officer, evaluated the effectiveness of our disclosure controls and procedures as of June 30, 2007. The term disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act, means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company's management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Based on the evaluation of our disclosure controls and procedures as of June 30, 2007, our chief executive officer and chief financial officer concluded that, as of such date, the Company's disclosure controls and procedures were effective at the reasonable assurance level.

No change in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) occurred during the quarter ended June 30, 2007 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## **PART II OTHER INFORMATION**

### **ITEM 1. LEGAL PROCEEDINGS**

On June 19, 2007, FotoMedia Technologies, LLC filed a lawsuit in the Eastern District of Texas against Shutterfly, America Online, Inc., Photobucket.com, Inc., CNET Networks, Inc. and Yahoo! Inc., alleging that the defendants infringe three U.S. patents (U.S. Patent No. 6,018,774, No. 6,542,936 and No. 6,871,231). The plaintiff is seeking treble damages, attorneys' fees, and an injunction against all parties including Shutterfly, based on unspecified allegations of infringement of the three patents listed above. We were served with the complaint and our response is currently due August 24, 2007. We dispute the plaintiff's claims, believe that we have meritorious defenses and intend to vigorously defend this action. At this time, we do not believe that the amount of potential loss, if any, is reasonably estimable.

On August 29, 2006, our former Chief Financial Officer, Virender Ahluwalia, sued Shutterfly in San Mateo County Superior Court alleging causes of action for reformation of contract, breach of contract and breach of fiduciary duty. The plaintiff claims that he is entitled to exercise stock options for an additional 15,535 shares of our common stock because his vesting schedule should be deemed to have started one year earlier than the date stated in Shutterfly's corporate records. In addition, plaintiff claims that we initially did not advise him that withholding taxes were due at the time of exercise of his nonqualified stock options to purchase 277,139 shares of our common stock in 2005, but that we later modified that tax advice, extended his option exercise date, and required that he make provision for the applicable withholding taxes at the time of exercise of such options. The plaintiff claims he was damaged by having to immediately sell a portion of those shares upon his exercise in order to raise the funds necessary to pay applicable withholding taxes. He also claims that our calculation of the fair market value of the shares for the purpose of calculating his tax liability was improper. The plaintiff is seeking compensatory and punitive damages. In October 2006, we filed a Petition to Compel Arbitration and to stay the litigation pending arbitration, and the plaintiff has now stipulated to arbitration of the dispute. The parties have engaged in discovery in the Arbitration and the Company has recently moved for summary judgment on the claims, which the plaintiff has opposed. We dispute the plaintiff's claims, believe that we have meritorious defenses and intend to vigorously defend this action. At this time, we do not believe that the amount of potential loss, if any, is reasonably estimable.

In addition, in the ordinary course of our business, we are also subject to periodic lawsuits, investigations and claims. Although we cannot predict with certainty the ultimate resolution of lawsuits, investigations and claims asserted against us, we do not believe that any other currently pending legal proceeding to which we are a party is likely to harm our business, results of operations, cash flows or financial condition.

### **ITEM 1A. RISK FACTORS**

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

Our business is highly seasonal, with a high proportion of our net revenues, net income and operating cash flows generated during the fourth quarter. For example, we generated approximately 53% of our net revenues for 2006 in the fourth quarter of 2006, and the



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net income that we generated during the fourth quarter of 2006 was necessary for us to achieve profitability on an annual basis for 2006. In addition, we incur significant additional expenses in the period leading up to the fourth quarter holiday season in anticipation of higher sales volume in that period, including expenses related to the hiring and training of temporary workers to meet our seasonal needs, additional inventory and equipment purchases and increased advertising. If we are unable to accurately forecast and respond to consumer demand for our products during the fourth quarter, our financial results, reputation and brand will suffer and the market price of our common stock would likely decline.

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

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

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

We believe that we must significantly grow our current production capability to meet our projected revenue targets. We expect to spend between \$12 million and \$15 million in capital expenditures in the remainder of 2007, a portion of which we expect will be used to add manufacturing capacity. We have announced that we are opening a new manufacturing and production plant in Charlotte, North Carolina, which is planned to be fully operational in accordance with our current production plan by the fourth quarter 2007. Our inability to launch our Charlotte facility on-time, or meet our seasonal production requirements, could lead to customer dissatisfaction and damage to our reputation and brand, which would result in reduced net revenues. Moreover, if the costs of meeting production requirements were to exceed our expectations, our results of operations would be harmed.

In addition, we face significant production risks at peak holiday seasons, including the risks of obtaining sufficient qualified seasonal production personnel. A majority of our workforce during the fourth quarter of 2006 was seasonal, temporary personnel. We have had difficulties in the past finding a sufficient number of qualified seasonal employees, and our failure to obtain qualified seasonal production personnel both in our Hayward, CA and Charlotte, NC production plants could harm our operations.

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

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

demand for our products and services, including seasonal demand;

our pricing and marketing strategies and those of our competitors;

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

our ability to retain customers and encourage repeat purchases, particularly our high-volume customers from whom we derive a high proportion of our net revenues;

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

the costs of customer acquisition;

our ability to manage our production and fulfillment operations;

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

the costs of expanding or enhancing our technology or website;

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

declines or disruptions to the travel industry;

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

the timing of holidays;

volatility in our stock price, which may lead to higher stock-based compensation expense under newly adopted accounting standards;

consumer preferences for digital photography services; and

improvements to the quality, cost and convenience of desktop printing of digital pictures and products.

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

***We have incurred operating losses in the past and may not be able to sustain profitability in the future. Recent accounting changes may make it more difficult for us to sustain profitability.***

We have periodically experienced operating losses since our inception in 1999. In particular, we make investments in our business that generally result in operating losses in each of the first three quarters of our fiscal year. This typically enables us to generate the majority of our net revenue during the fourth quarter and to achieve profitability for the full fiscal year. If we are unable to produce our products and provide our services at commercially reasonable costs, if revenues decline or if our expenses exceed our expectations, we may not be able to sustain or increase profitability on a quarterly or annual basis. Also, as a publicly-traded company, we are subject to the Sarbanes-Oxley Act of 2002, which will soon require that our internal controls and procedures comply with Section 404 of the Sarbanes-Oxley Act. We expect compliance to be costly and it could impact our results of operations in future periods. In addition, the Financial Accounting Standards Board now requires us to follow Statement No. 123 (revised 2004), Share Based Payment, or SFAS No. 123R. Under SFAS No. 123R, companies must calculate and record in their statement of operations the cost of equity instruments, such as stock options or restricted stock, awarded to employees for services received beginning in the first quarter of the 2006 fiscal year. We expect that we will continue to use stock options to attract, incentivize and retain our employees and will therefore incur the resulting stock-based compensation expense. This will continue to adversely affect our operating results in future periods.

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

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

maintain and increase our number of customers;

maintain and enhance our brand;

maintain and grow our website and customer operations;

enhance and expand our products and services;

successfully execute our business and marketing strategy;

continue to develop and upgrade our technology and information processing systems;

continue to enhance our service to meet the needs of a changing market;

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provide superior customer service;

respond to competitive developments; and

attract, integrate, retain and motivate qualified personnel.

We may be unable to accomplish one or more of these things, which could cause our business to suffer. If we do accomplish one or more of these things, it might be very expensive, which could harm our financial results.

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

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

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

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

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

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

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

We have grown from 212 employees as of June 30, 2006 to 331 employees as of June 30, 2007. We have website operations, offices and customer support centers in Redwood City, California and a production facility in Hayward, California. Our growth has placed, and will continue to place, a strain on our administrative and operational infrastructure. We have announced that we are opening a new manufacturing and production plant in Charlotte, North Carolina, which is planned to be fully operational by the fourth quarter 2007. Our ability to manage our operations and growth will require us to continue to refine our operational, financial and management controls, human resource policies and reporting systems.

If we are unable to manage future expansion, we may not be able to implement improvements to our controls, policies and systems in an efficient or timely manner and may discover deficiencies in existing systems and controls. Our ability to provide a high-quality

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customer experience could be compromised, which would damage our reputation and brand and substantially harm our business and results of operations.

***Competitive pricing pressures, particularly with respect to 4x6 print pricing and shipping, may harm our business and results of operations.***

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

Changes in our pricing strategies have had, and may continue to have, a significant impact on our net revenues and net income. For example, in the second quarter of 2005, certain of our competitors reduced the list prices of their 4x6 prints from \$0.19 to \$0.12. In response, we lowered the list price of our 4x6 prints from \$0.29 to \$0.19 in order to remain competitive. A drop in our 4x6 prices, due to competitive pressures or otherwise, without a corresponding increase in volume would negatively impact our net revenues and could adversely affect our gross margins.

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

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

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

Online digital photography services companies such as Kodak EasyShare Gallery (formerly known as Ofoto), Snapfish, which is a service of Hewlett-Packard, Sony ImageStation, and others;

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

Drug stores such as Walgreens, CVS and others that offer in-store pick-up from Internet orders;

Regional photography companies such as Wolf Camera and Ritz Camera that have established brands and customer bases in existing photography markets;

Internet portals and search engines such as Yahoo!, AOL, Google and CNET that offer broad-reaching digital photography and related products and services to their large user bases;

Home printing service providers such as Hewlett-Packard, Epson and Canon, that are seeking to expand their printer and ink businesses by gaining market share in the emerging digital photography marketplace; and

Photo-related software companies such as Adobe, Apple, Microsoft, Corel and others.

Many of our competitors have significantly longer operating histories, larger and broader customer bases, greater brand and name recognition and greater financial, research and development and distribution resources than we do. The numerous choices for digital photography services can cause confusion for consumers, and may cause them to select a competitor with greater name recognition.



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Some competitors are able to devote substantially more resources to website and systems development, or to investments or partnerships with traditional and online competitors. Competitors that are well-funded (particularly new entrants) may choose to prioritize growing their market share and brand awareness instead of profitability. Competitors and new entrants in the digital photography products and services industries may develop new products, technologies or capabilities that could render obsolete or less competitive many of the products, services and content that we offer. We may be unable to compete successfully against current and future competitors, and competitive pressures could harm our business and prospects.

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

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

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

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

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

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

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

In addition, various private entities attempt to regulate the use of e-mail for commercial solicitation. These entities often advocate standards of conduct or practice that significantly exceed current legal requirements and classify certain e-mail solicitations that comply with current legal requirements as unsolicited bulk e-mails, or spam. Some of these entities maintain blacklists of companies and individuals, and the websites, Internet service providers and

Internet protocol addresses associated with those entities or individuals that do not adhere to what the blacklisting entity believes are appropriate standards of conduct or practices for commercial e-mail solicitations. If a company's Internet protocol addresses are listed by a blacklisting entity, e-mails sent from those addresses may be blocked if they are sent to any Internet domain or Internet address that subscribes to the blacklisting entity's service or purchases its blacklist. From time to time we are blacklisted, which could impair our ability to market our products and services, communicate with our customers and otherwise operate our business.

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

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

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

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

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

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

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

- the inability to physically handle and examine product samples;

- delivery time associated with Internet orders;

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

- delayed shipments or shipments of incorrect or damaged products; and

- inconvenience associated with returning or exchanging purchased items.

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



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

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

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

Our ability to successfully receive and fulfill orders and to provide high-quality customer service depends in part on the efficient and uninterrupted operation of our computer and communications systems. Substantially all of the computer hardware necessary to operate our website is located at a single third-party hosting facility in Santa Clara, California, and our production facility is in Hayward, California. We are also opening a new manufacturing and production plant in Charlotte, North Carolina, which is planned to be fully operational by the fourth quarter 2007. Our systems and operations could suffer damage or interruption from human error, fire, flood, power loss, insufficient power availability, telecommunications failure, break-ins, terrorist attacks, acts of war and similar events. In addition, Hayward is located on, and Santa Clara is located near, a major fault line, increasing our susceptibility to the risk that an earthquake could significantly harm the operations of these facilities. Our business interruption insurance may be insufficient to compensate us for losses that may occur. We do not presently have redundant systems in multiple locations, although we plan to have an additional data center in our new facility in Charlotte. In addition, the impact of any of these disasters on our business may be exacerbated by the fact that we are still in the process of developing our formal disaster recovery plan and we do not have a final plan currently in place.

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

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

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

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

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

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

We have historically relied on an exclusive supply relationship with Fuji Photo Film U.S.A. to supply all of our photographic paper for silver halide print production, such as 4x6 prints. We have an agreement with Fuji that expires in April 2010, but if Fuji fails to perform in accordance with the terms of our agreement and if we are unable to secure a paper supply from a different source in a timely manner, we would likely fail to meet customer expectations, which

could result in negative publicity, damage our reputation and brand and harm our business and results of operations. We purchase other photo-based supplies from third parties on a purchase order basis, and, as a result, these parties could increase their prices, reallocate supply to others, including our competitors, or choose to terminate their relationship with us. In addition, we purchase or rent the machines used to produce certain of our photo-based products from Hewlett-Packard, which is one of our primary competitors in the area of online digital photography services. This

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competition may influence their willingness to provide us with additional products or services. If we were required to switch vendors of machines for photo-based products, we may incur delays and incremental costs, which could harm our operating results.

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

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

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

Although historically we have focused our business on consumer markets for silver halide prints, such as 4x6 prints, and photo-based products, such as photo books and calendars, we intend to address, and demand may shift to, new products and services. In addition, we believe we may need to address additional markets and expand our customer demographic in order to further grow our business. We may not successfully expand our existing services or create new products and services, address new market segments or develop a significantly broader customer base. Any failure to address additional market opportunities could result in loss of market share, which would harm our business, financial condition, and results of operations.

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

A key component of our business strategy includes strengthening our competitive position and refining the customer experience on our website through internal development. However, from time to time, we may selectively pursue acquisitions of businesses, like our June 2007 acquisition of Make it About Me! ( MIAM ), and other technologies or services. Integrating any newly acquired businesses, technologies or services is likely to 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 the acquired businesses profitably or otherwise implement our strategy successfully. If we are unable to integrate MIAM, or any other newly acquired entities, technologies or services effectively, our business and results of operations will suffer. The time and expense associated with finding suitable and compatible businesses, technologies or services could also disrupt our ongoing business and divert our management's attention. Future acquisitions by us could also result in large and immediate write-offs or assumptions of debt and contingent liabilities, any of which could substantially harm our business and results of operations.

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

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

***If we fail to develop and maintain adequate internal controls, we may be unable to timely and accurately record, process and report financial data, fail to meet our periodic reporting obligations or have material misstatements in our financial statements. These events could lead to a decline in our stock price.***

## Edgar Filing: SHUTTERFLY INC - Form 10-Q

In connection with the audit of our 2005 consolidated financial statements for the year ended and as of December 31, 2005 and the review of our 2006 quarterly financial statements for the quarter ended June 30, 2006, our independent registered public accounting firm identified three control deficiencies that represented material weaknesses in our internal control over financial reporting. As of December 31, 2006, we had remediated the previously disclosed material weaknesses. However, we can give no assurance that further



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material weaknesses will not be identified in the future. If further material weaknesses in our internal control are identified, this could cause our investors to lose confidence in the accuracy and completeness of our financial reports, leading to a decline in our stock price.

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

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

As of June 30, 2007, we had 18 patents issued and more than 30 patent applications pending in the United States. We intend to pursue corresponding patent coverage in other countries to the extent we believe such coverage is appropriate and cost efficient. We cannot ensure that any of our pending applications will be granted. In addition, third parties have in the past and could in the future bring infringement, invalidity, co-inventorship or similar claims with respect to any of our currently issued patents or any patents that may be issued to us in the future. Any such claims, whether or not successful, could be extremely costly, could damage our reputation and brand and substantially harm our business and results of operations.

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

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

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

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

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

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

We currently are the registrant of the Internet domain name for our website, Shutterfly.com, as well as various related domain names. Domain names generally are regulated by Internet regulatory bodies and are controlled also by trademark and other related laws. The regulations governing domain names could change in ways that block or interfere with our ability to use relevant domains. Also, we might not be able to prevent third parties from registering or retaining domain names that interfere with our consumer

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communications, or infringe or otherwise decrease the value of our trademarks and other proprietary rights. Regulatory bodies also may establish additional generic or country-code top-level domains or modify the requirements for holding domain names. As a result, we might not be able to acquire or maintain the domain names that utilize the name Shutterfly in all of the countries in which we currently or intend to conduct business. This could substantially harm our business and results of operations.

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

Our policies concerning the collection of sales and use taxes and the payment of certain corporate level taxes has been based upon decisions of the U.S. Supreme Court that determine when a taxpayer is deemed to have nexus with a state sufficient to impose tax obligations under the Commerce Clause of the U.S. Constitution. Those Court decisions require that the taxpayer be physically present before a state can require the collection of sales and use taxes. However, the standard governing the collection of other taxes (e.g., corporate income taxes) is less established and a number of state courts have recently concluded that the Commerce Clause requires economic (essentially marketing activities and customers) rather than physical presence to impose taxes other than sales and use taxes.

In reliance upon the U.S. Supreme Court's decisions, we have continued to collect sales and use taxes and pay certain corporate level taxes in California, Nevada, Pennsylvania and North Carolina where the Companies has employees and/or property. Starting in June 2007, the Company has also begun collecting sales and use taxes and paying certain corporate level taxes in other states where the Company has implemented its joint sales effort with Target Corporation, described above.

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

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

We recently resolved an audit examination by the State of California for the 2003 tax year, and the result of that examination reduced our effective tax rate by 0.7%. Future audits of other tax years or by other taxing authorities could also lead to fluctuations in our effective tax rate because the taxing authority may disagree with certain assumptions we have made regarding appropriate credits and deductions in filing our tax returns.

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

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

We are subject to general business regulations and laws as well as regulations and laws specifically governing the Internet and e-commerce. Existing and future laws and regulations may impede the growth of the Internet or other online services. These regulations and laws may cover taxation, restrictions on imports and exports, customs, tariffs, user privacy, data protection, pricing, content, copyrights, distribution, electronic contracts and other communications, consumer protection, the provision of online payment services, broadband residential Internet access and the characteristics and quality of products and services. It is not clear how existing laws governing issues such as property ownership, sales and other taxes, libel and personal privacy apply to the Internet and e-commerce as the vast majority of these laws were adopted prior to the advent of the Internet and do not contemplate or address the unique issues raised by the Internet or e-commerce. Those laws that do reference the Internet are only beginning to be interpreted by the courts and their applicability and reach are therefore uncertain. For example, the Digital Millennium Copyright Act, or DMCA, is intended, in part, to limit the liability of eligible online service providers for listing or linking to third-party websites that include materials that infringe copyrights or other rights of others. Portions of the

Communications Decency Act, or CDA, are intended to provide statutory protections to online service providers who distribute third-party content. We rely on the protections provided by both the DMCA and CDA in conducting our business. Any changes in these laws or judicial interpretations narrowing their protections will subject us to greater risk of liability and may increase our costs of compliance with these regulations or limit our ability to operate certain lines of business. The Children's Online Protection Act and the Children's Online Privacy Protection Act are

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intended to restrict the distribution of certain materials deemed harmful to children and impose additional restrictions on the ability of online services to collect user information from minors. In addition, the Protection of Children From Sexual Predators Act of 1998 requires online service providers to report evidence of violations of federal child pornography laws under certain circumstances. The costs of compliance with these regulations may increase in the future as a result of changes in the regulations or the interpretation of them. Further, any failures on our part to comply with these regulations may subject us to significant liabilities. Those current and future laws and regulations or unfavorable resolution of these issues may substantially harm our business and results of operations.

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

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

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

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

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

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

In addition, under current credit card practices, we are liable for fraudulent credit card transactions because we do not obtain a cardholder's signature. We do not currently carry insurance against this risk. To date, we have experienced minimal losses from credit card fraud, but we continue to face the risk of significant losses from this type of fraud.

Our failure to adequately control fraudulent credit card transactions could damage our reputation and brand and substantially harm our business and results of operations.

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

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

### ***Expansion of our international operations will require management attention and resources and may be unsuccessful, which could harm our future business development and existing domestic operations.***

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

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

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

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

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

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

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

- price and volume fluctuations in the overall stock market;

- changes in operating performance and stock market valuations of other technology companies generally, or those in our industry in particular;

the financial projections we may provide to the public, any changes in these projections or our failure to meet these projections;

changes in financial estimates by any securities analysts who follow our company, our failure to meet these estimates or failure of those analysts to initiate or maintain coverage of our stock;



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ratings downgrades by any securities analysts who follow our company;

the public's response to our press releases or other public announcements, including our filings with the SEC;

announcements by us or our competitors of significant technical innovations, acquisitions, strategic partnerships, joint ventures or capital commitments;

introduction of technologies or product enhancements that reduce the need for our products;

market conditions or trends in our industry or the economy as a whole;

the loss of key personnel;

lawsuits threatened or filed against us;

future sales of our common stock by our executive officers, directors and significant stockholders; and

other events or factors, including those resulting from war, incidents of terrorism or responses to these events.

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

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

our board is classified into three classes of directors, each with staggered three-year terms;

only our chairman, our chief executive officer, our president or a majority of our board of directors is authorized to call a special meeting of stockholders;

our stockholders may take action only at a meeting of stockholders and not by written consent;

vacancies on our board of directors may be filled only by our board of directors and not by stockholders;

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

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

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

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

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

**Unregistered Sales of Equity Securities**

Not applicable

**Table of Contents****Use of Proceeds**

The S-1 relating to our initial public offering was declared effective by the SEC on September 28, 2006.

Through June 30, 2007, we had not utilized any of the net proceeds from the offering. We intend to use the net proceeds of the offering for general corporate purposes, including working capital and potential capital expenditures for manufacturing and website infrastructure equipment and new and existing manufacturing facilities. We expect our capital expenditures to be between \$12 million and \$15 million during the remainder of 2007, which will be funded by a combination of our cash and cash equivalents, expected cash flows from operations and the net proceeds from the offering. We expect to spend a portion of this amount to purchase manufacturing equipment, obtain new manufacturing facilities and on improvements to our new and existing manufacturing facilities. The remainder will be allocated for the purchase of website infrastructure equipment. Although we may also use a portion of the net proceeds for the acquisition of, or investment in, companies, technologies, products or assets that complement our business, we have no present understandings, commitments or agreements to enter into any acquisitions or make any investments.

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

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

Not applicable

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

Our Annual Meeting of Stockholders was held on May 17, 2007. The following two proposals were adopted:

Proposal I: To elect the following directors of the Company to serve until the next Annual Meeting of Stockholders or until their successors are duly elected and qualified:

| Nominee             | For        | Withheld |
|---------------------|------------|----------|
| Nancy J. Schoendorf | 13,153,601 | 87,642   |
| Eric J. Keller      | 13,163,043 | 78,200   |

The following directors who were not nominees for election at this Annual Meeting will continue to serve on the Board of Directors of the Company: Philip Marineau, Jeffrey Housenbold, Pat House, Stephen Killeen, and Jim White.

Proposal II: To ratify the appointment of PricewaterhouseCoopers LLP as the Company's independent registered public accounting firm for the fiscal year ending December 31, 2007.

| For        | Against | Abstain |
|------------|---------|---------|
| 13,236,664 | 4,175   | 404     |

There were no broker non-votes for these proposals

**ITEM 5. OTHER INFORMATION**

Not applicable

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**ITEM 6. EXHIBITS**

**Exhibit**

**Number**

**Description**

|       |   |
|-------|---|
| 10.18 | Supply Agreement, dated as of April 20, 2007, by and between the Company and FujiFilm U.S.A., Inc.                        |
| 31.01 | Certification of Chief Executive Officer Pursuant to Securities Exchange Act Rule 13a-14(a).                              |
| 31.02 | Certification of Chief Financial Officer Pursuant to Securities Exchange Act Rule 13a-14(a).                              |
| 32.01 | Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350 and Securities Exchange Act Rule 13a-14(b).** |
| 32.02 | Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350 and Securities Exchange Act Rule 13a-14(b).** |

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

Confidential treatment requested for

portions of this  
Agreement.

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**SIGNATURES**

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

**SHUTTERFLY, INC.**

(Registrant)

Dated: August 1, 2007

By: /s/ Jeffrey T. Housenbold

**Jeffrey T. Housenbold,  
President and Chief Executive  
Officer**

Dated: August 1, 2007

By: /s/ Stephen E. Recht

**Stephen E. Recht,  
Chief Financial Officer**

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**INDEX TO EXHIBITS**

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

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

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