shutterfly®

2009 ANNUAL REPORT

Shutterfly, Inc.

LETTER TO STOCKHOLDERS

Dear Shutterfly Stockholder:

We are pleased to report our 2009 performance. Shutterfly made great strides during the year and despite a fragile economy, delivered record revenues and free cash flows. We continue to address a number of multi-billion dollar markets that have just begun to be transformed by technology, and our strong execution against our strategy continues to deliver positive results. By leveraging our unique set of assets, including our user-facing web-based platform, strong brand equity, loyal customer base, integrated marketing skills, state-of-the-art print-on-demand capabilities and IP portfolio, across these large markets, we are well positioned for continued growth.

2009: Focus, Execution and Investment

I am very proud of the Shutterfly team as they delivered strong results despite a tough macro-economic environment. Our strategic investments throughout the year combined with our focus on strong execution, innovation and improved efficiencies led to record financial results.

During the year, we enhanced our products, services and user experience, strengthened our brand through differentiated and integrated marketing, manufactured high-quality, high-engagement products and incubated new businesses that leverage our manufacturing assets and our active customer base. As a result, our net revenues totaled $246.4 million, a 15% year-over-year increase; Adjusted EBITDA[1] was $50.2 million, a 31% year-over-year increase; and free cash flows[2] totaled $32.5 million, a 108% increase from 2008.

We continue to increase our market share in the Photo Books, Cards and Stationery and Memory Sharing categories and explore opportunities in the mobile and social space. We enhanced on our award-winning Photo Book line with the launch of Simple Path, which enables one-click creation and ordering of elegantly designed Photo Books. We also expanded our Photo Book offering to include new sizes, covers and form factors. Our stylish Cards and Stationery collection is comprised of exclusive designs from our internal design team and world-renowned third-party designers. Throughout 2009, we expanded our line and launched thousands of new designs, ensuring that our customers had the perfect way to express themselves across a number of occasions, especially during the busy fourth quarter holiday season.

In addition to our compelling line of products, we continue to successfully grow our services offering with a focus on our Share Sites. The goal of Shutterfly Share Sites is to be the best place on the web where families, friends and groups can create their own secure websites to stay connected and share memories. Based largely on customer feedback, we made hundreds of enhancements to our Share Sites, including the addition of video, while improving site creation, engagement rates and monetization. In time for the fall sports season, we launched our Youth Sports Share Sites to make it easier for parents, players and coaches to have the best organized, most engaged and memorable season possible.

To complement our robust services, we invested in the growing mobile and social media space, providing new ways for people to share their memories while on the go. We launched our first application for the iPhone and iPod Touch, Shutterfly for iPhone, which allows customers to view, share, upload and preserve their memories directly from their mobile device. We acquired Tiny Pictures and in December, this team launched Wink, a new service that combines real-time photo sharing with photo printing for the social networking generation. Wink enables customers to create and share printed photo strips using pictures from Shutterfly, iPhones and social network sites like Facebook and Flickr.

On the marketing and user experience front, we also had a successful year. We continue to take an integrated approach to our marketing efforts and launched coordinated micro sites for the New Mom and Bridal occasions, with tips, tricks and inspiration to complement our new stationery offerings. Throughout 2009 we grew our presence on emerging social media channels like Facebook and Twitter to increase awareness, build brand favorability, and gain customer insights. We also made significant progress improving our funnel conversion metrics in 2009. We launched a newly designed homepage, storefront and MyShutterfly page, which positively impacted registration, retention and conversion rates.

Our Manufacturing team successfully shut-down operations in Hayward, California, seamlessly opened a new state-of-the-art facility in Phoenix, Arizona to compliment our Charlotte, North Carolina plant, and delivered continuous improvement in throughput, quality and efficiency. Our commercial print initiative continues to gain momentum, particularly given the tough macro-economic climate and the early stage nature of the program. The team delivered $3.8M in revenue while further developing our suite of products, services and capabilities that will improve the business in 2010 and beyond.

2010: Innovation, Execution and Financial Discipline

In 2010, we will continue our momentum and work to extend our lead in the Photo Book, Cards and Stationery, and Memory Sharing markets through innovation, design forward products and services, customer friendly policies and industry-leading quality. This approach, combined with our commitment to solid execution and financial discipline, will enable us to achieve our goals of increasing revenue, free-cash flows and long-term shareholder value.

I want to personally thank our customers for their continued loyalty and patronage and our employees and partners for their tremendous contributions throughout the entire year. On behalf of the team here at Shutterfly, I thank our stockholders for their continued support.

Sincerely,

Jeff Housenbold, CEO

1 Adjusted EBITDA is a non-GAAP financial measure which we define as earnings before interest, taxes, depreciation, amortization and stock-based compensation. For a reconciliation to the most directly comparable GAAP measure, please refer to page 46 of our Annual Report on Form 10-K.

2 Free cash flows is a non-GAAP financial measure that we define as Adjusted EBITDA less purchases of property and equipment and capitalization of software and website development costs. For a reconciliation to the most directly comparable GAAP measure, please refer to page 46 of our Annual Report on Form 10-K.

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

Form 10-K

(Mark One)

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

For the fiscal year ended December 31, 2009

or

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

For the transition period from to

Commission file number: 001-33031

SHUTTERFLY, INC.

(Exact Name of Registrant as Specified in Its Charter)

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

Registrant's telephone number, including area code
(650) 610-5200

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

Title of Each Class	Name of Each Exchange on Which Registered
Common Stock, $0.0001 Par Value Per Share	Nasdaq Global Market

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

None

Indicate by check mark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ☐ No ☑

Indicate by check mark if the Registrant is not required to file reports pursuant to Section 13 or 15(d) of the Act. Yes ☐ No ☑

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

Indicate by check mark whether the Registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the Registrant was required to submit and post such files). Yes ☐ No ☐

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

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

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

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

As of June 30, 2009, the last business day of our most recently completed second fiscal quarter, the aggregate market value of our Common Stock held by non-affiliates based on the closing price or our Common Stock on June 30, 2009 as reported on the NASDAQ Global Market was $354,553,265.

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

Class	Outstanding at February 5, 2010
Common stock, $0.0001 par value per share	25,909,738 shares

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the documents listed below have been incorporated by reference into the indicated parts of this report, as specified in the responses to the item numbers involved:

Designated portions of the Proxy Statement relating to the 2010 Annual Meeting of the Stockholders to be held on May 20, 2010 (the "Proxy Statement"): Part III (Items 10, 11, 12, 13 and 14). Except with respect to information specifically incorporated by reference in the Form 10-K, the Proxy Statement is not deemed to be filed as part hereof.

Shutterfly, Inc.
Table of Contents

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PART I

Except for historical financial information contained herein, the matters discussed in this Form 10-K may be considered forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, and subject to the safe harbor created by the Securities Litigation Reform Act of 1995. Such statements include declarations regarding our intent, belief, or current expectations and those of management. Prospective investors are cautioned that any such forward-looking statements are not guarantees of future performance and involve a number of risks, uncertainties and other factors, some of which are beyond our control; actual results could differ materially from those indicated by such forward-looking statements. Important factors that could cause actual results to differ materially from those indicated by such forward-looking statements include, but are not limited to: (i) that the information is of a preliminary nature and may be subject to further adjustment; (ii) those risks and uncertainties identified under "Risk Factors;" and (iii) the other risks detailed from time-to-time in our reports and registration statements filed with the Securities and Exchange Commission, or SEC. Except as required by law, we undertake no obligation to revise or update publicly any forward-looking statements, whether as a result of new information, future events or otherwise.

ITEM 1. *BUSINESS.*

Overview

Shutterfly, Inc. was incorporated in Delaware in 1999. In September 2006, we completed our initial public offering and our common stock is listed on the Nasdaq Global Market under the symbol "SFLY." Our principal corporate offices are located in Redwood City, California.

We are an Internet-based social expression and personal publishing service that enables consumers to share, print and preserve their memories by leveraging our technology, manufacturing, web-design and merchandising capabilities. Our vision is to make the world a better place by helping people share life's joy. Our mission is to build an unrivaled service that enables deeper, more personal relationships between our customers and those who matter most in their lives. Our primary focus is on helping consumers manage their memories through the powerful medium of photography. We provide a full range of personalized photo-based products and services that make it easy, convenient and fun for consumers to upload, edit, enhance, organize, find, share, create, print and preserve their memories in a creative and thoughtful manner.

We generate the majority of our revenues by producing and selling professionally-bound photo books, greeting cards and stationery, personalized calendars, other photo-based merchandise and high-quality prints ranging in size from wallet-sized to jumbo-sized 20x30 enlargements. We currently manufacture these items in our Charlotte, North Carolina and Phoenix, Arizona manufacturing facilities. Our new manufacturing and production facility in Phoenix, Arizona began operations in April 2009, and replaced our Hayward, California facility, which ceased operations in January 2009. By controlling the production process in our own manufacturing facilities, we are able to produce high-quality products, innovate rapidly, maintain a favorable cost structure and ensure timely shipment to customers, even during peak periods of demand. Additionally, we sell a variety of print and photo-based merchandise that is currently manufactured for us by third parties, such as calendars, mugs, canvas prints, mouse pads, magnets and puzzles. We generate substantially all of our revenue from sales originating in the United States and our sales cycle has historically been highly seasonal as we generate more than 50% of our revenue during our fiscal fourth quarter. During fiscal year 2009, we fulfilled 7.9 million orders, to 3.3 million customers, at an average order value of $30.74 per order.

Our high-quality products and services and the compelling online experience we create for our customers, combined with our focus on continuous innovation, have allowed us to establish a premium brand. We realize the benefits of a premium brand through high customer loyalty, low customer acquisition costs and premium pricing.

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

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

Business and Marketing Strategy

We drive business and marketing strategies within three key categories: Personalized Products and Services ("PPS"), Prints, and Commercial Print. To support our business strategies within these categories, we use a variety of integrated marketing programs, including advertising, direct marketing technologies and strategic alliances. These methods include direct marketing over the Internet, e-mail marketing to prospects and existing customers, search engine marketing, and traditional direct marketing mailings such as postcards and seasonal catalogs. In addition, because many of our products are either shared over the Internet or given as gifts, the appearance of our brand on the products and packaging provides ongoing viral advertising.

We place targeted advertisements on websites and in publications, contract for targeted e-mail marketing services and contract for advertising placement on leading search engines. We also maintain an affiliate program under which we pay program participants for referral sales generated from hyperlinks to our website from the affiliate's website and in promotional materials.

In addition, to support our commercial print initiative, we have hired a small sales force to engage with marketing fulfillment organizations and advertisers for commercial print services.

The following paragraphs summarize our business strategies within these three categories:

Personalized Products and Services

Personalized products and services ("PPS") are comprised of our photo book products, greeting cards and stationery, and other photo-based merchandise. In addition, PPS also includes revenues from advertising and sponsorship activities. We also provide website services which include our share platform called Share Sites, developed from our 2008 acquisition of Nexo Systems, Inc. Personalized products and services as a percentage of total net revenue was 56% in 2007, 61% in 2008 and 66% in 2009. Within this category, we seek to drive the following strategies:

Enhance product and services offerings. We have focused substantive efforts in enhancing the products and services we offer in our PPS category. Specifically, we have introduced a wide range of premium designer greeting cards and stationery for many occasions, including holidays, baby announcements, birthdays, and weddings. During 2009, we launched the Simple Path feature which instantly creates photo books in all sizes and formats, making it easier and faster for customers to create their photo books. We also have a Storyboard feature that helps customers organize their pictures and create custom photo books. We continue to expand and develop our sharing platform called Share Sites that enables customers to create personalized, secure websites for school activities, clubs and other tight-knit social groups. During 2009, we launched new templates and functionality for our Share Sites designed to support parents and coaches who manage team sports like soccer. We also offer the ability to upload, store, and share a limited number of video clips for free and a video subscription service that provides unlimited video storage, larger file sizes, and HD-quality video playback.

Expand our customer base. We intend to leverage our PPS offerings, and to promote the Shutterfly brand through word-of-mouth referrals from existing customers, print advertising, catalogs, online advertising, search engine marketing and complementary alliances with other companies. We also leverage our Share Sites platform to drive increased awareness of our brand and our product offerings, as well as increase the engagement of existing customers. In addition, we have expanded our presence across social networks by enabling customers to post their photo books onto a variety of social networking and blogging websites such as Facebook, MySpace, Twitter, and Blogger.

Increase sales to existing customers. We intend to increase both average order value and repeat orders per customer by expanding our products and services, tailoring our offerings to encourage additional purchases for different holidays and life events and increasing our cross-selling and up-selling activities. We have specifically focused on features that make it easier for customers to personalize products, such as the launch of Simple Path, and offerings that provide new and different occasions to engage with Shutterfly, such as our expanded set of cards and stationery designs.

Develop new lines of business and strategic relationships with complementary business. We continue to focus our efforts to expand our advertising and sponsorship line of business within the PPS category. Our loyal customer base has depth in many key demographics, and we seek to continue to monetize that base in a way that is consistent with our premium brand. In addition, we develop strategic relationships with complementary businesses, such as our relationship with Target, Inc, which provides an alternate sales channel for our products. This and other strategic relationships also drive direct customer trial and acquisition, co-marketing opportunities, and opportunities to display the Shutterfly brand to new audiences.

Prints

Our Prints offerings include 4x6 prints, as well as other print sizes ranging from wallet sized to jumbo-sized 20x30 enlargements, and photocards. During the last three years, our Prints revenues as a percentage of total revenues have declined from 44% in 2007, to 39% in 2008, and to 33% in 2009. Despite these decreases, we continue to utilize our Prints category to drive new and continued engagement with the Shutterfly Brand, and we continue to innovate in this category. In September 2009, we completed our acquisition of TinyPictures and in December 2009, we launched Wink, a new mobile service which enables customers to create, order, and mail customized photo strips using photos from their iPhone, Facebook, and Flickr accounts.

Commercial Print Services

In 2008, we launched our Commercial Printing business initiative. The primary objective of this initiative was to leverage our large installed base of existing variable digital presses to provide commercial printing services primarily to the direct marketing industry, and utilize idle print capacity during low volume periods. In 2008, we generated $0.4 million in revenue. In 2009, we expanded this initiative and generated approximately $3.8 million in revenue from customers such as Group O, a leading provider of marketing services, as well as many other advertisers and marketers. Commercial print contributed approximately 2% of our net revenues in 2009. We intend to continue to develop and grow this initiative during 2010.

Technology and Production Systems

We use a combination of proprietary and third-party technology, including the following:

Customer relationship management, or CRM, system. Our integrated CRM system is composed of various tools designed to convert first-time customers into repeat buyers. We seek to increase average order sizes by expanding customer awareness, providing targeted, segmented offers to customers and encouraging cross- and up-selling. The system uses a variety of data, including website usage patterns, order size, order frequency, products purchased, seasonality factors, image upload and share usage, as well as customer satisfaction information. This data is continually updated and refreshed in a data warehouse, from which different customer segments are identified and monitored on a continuing basis for targeted marketing communications.

By using this deep customer intelligence and ongoing analysis, we are able to offer customers a more personalized website experience and to target them with specific website promotions, discounts, specialized e-mail and direct mail offers. Our promotion engine generates special offers that are account specific and applied automatically at checkout.

We are also able to dynamically assign visitors to test and control groups who are shown different versions of our service. This form of A-B testing enables us to continuously optimize products, pricing, promotions and user interaction with our website.

Website system. We have designed our website system to be highly available, secure and cost-effective. We can scale to increasing numbers of customers by adding relatively inexpensive industry-standard computers and servers. We have a strong commitment to our privacy policy, and we utilize technologies such as firewalls, encryption technology for secure transmission of personal information between customers' computers and our website system and intrusion detection systems.

Image archive. We store our customers' images in our image archive. Once a customer uploads a photo to our website, it is copied to multiple redundant systems, including an off-site copy. We continue to expand our storage capacity to meet increasing customer demand. Our innovative storage architecture provides low storage costs, facilitates the safe, secure archiving of customers' images and delivers the speed and performance required to enable customers to access, enhance and edit their images in real-time.

Render farm. Once a customer orders a photo or any photo-based product or photo-based merchandise, our render farm technology performs fully automated image processing on the image prior to production. The customer's original uploaded image is retrieved from the image archive, and automatic algorithms enhance the color, contrast and sharpness of the image. The render farm also performs customer-requested edits such as crop, borders, customized back-printing and red-eye removal.

To ensure that output is of consistent quality, we apply our proprietary ColorSure technology during this render stage. ColorSure creates an automated mapping of the image's specific attributes to the printer's specific print calibrations and attributes, prior to production. For example, this technology allows a 4x6 print to look the same as a photo printed on an enlargement or in a photo book, even if they are ordered at separate times.

Production system. We operate our own production facilities in Charlotte, North Carolina and Phoenix, Arizona. Our new manufacturing and production facility in Phoenix, Arizona began operations in April 2009, and replaced our Hayward, California facility, which ceased operations in January 2009. Our automated production system controls our production processes, including order management and pick, pack and ship operations. Using proprietary algorithms, the production system analyzes tens of thousands of orders daily and automates the workflow into our high-volume silver halide photofinishing machines and our state-of-the-art digital presses.

Competition

The market for digital photography products and services is large, evolving and intensely competitive, and we expect competition to increase in the future. We face intense competition from a wide range of companies, including the following:

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

- “Big Box” retailers such as Wal-Mart, Costco and others that are seeking to offer low cost digital photography products and services. These competitors provide in-store fulfillment and self-service kiosks for printing, and may, among other strategies, offer their customers heavily discounted in-store products and services that compete directly with our offerings;
- drug stores such as Walgreens, CVS and others that offer in-store pick-up from Internet orders;
- regional photography companies such as Ritz Camera that have established brands and customer bases in existing photography markets;
- Internet portals and search engines such as Yahoo!, AOL, and Google that offer broad-reaching digital photography and related products and services to their large user bases;
- home printing service providers such as Hewlett-Packard, Epson, Canon, Kodak and Fuji that are seeking to expand their printer and ink businesses by gaining market share in the emerging digital photography marketplace;
- photo-related software companies such as Apple, Microsoft and Corel;
- social media companies that host images such as MySpace, Facebook and Hi5; and
- specialized companies in the photo book and stationery business such as Hallmark, American Greetings, Tiny Prints, Minted, Picaboo and Blurb.

We believe the primary competitive factors in attracting and retaining customers are:

- brand recognition and trust;
- quality of products and services;
- breadth of products and services;
- user affinity and loyalty;
- customer service;
- ease of use;
- convenience; and
- price.

We believe that we compete favorably with respect to many of these factors, particularly customer trust and loyalty, quality and breadth of products and services, and customer service. Many of our competitors promote their products on the basis of low prices or the convenience of same-day availability for digital photos printed in drugstores or other retail outlets. Generally, we distinguish ourselves from such competitors principally on the basis of product quality and innovation, rather than price or same-day delivery.

Intellectual Property

Protecting our intellectual property rights is part of our strategy for continued growth and competitive differentiation. We seek to protect our proprietary rights through a combination of patent, copyright, trade secret and trademark law. We enter into confidentiality and proprietary rights agreements with our employees, consultants and business partners, and control access to and distribution of our proprietary information. We have licensed in the past, and expect that we may license in the future, certain of our proprietary rights to third parties.

As of December 31, 2009, we had 35 issued patents, which expire at various dates between 2019 and 2028, and more than 20 patent applications pending in the United States. Our issued patents and patent applications relate generally to the user interface for our website, our computer network infrastructure and software, personalized photo-related products and automated workflow and digital printing. We intend to pursue corresponding patent coverage in additional countries to the extent we believe such coverage is appropriate and cost efficient. However, we cannot be certain that any of our pending or any future applications will be granted. In addition, third parties could bring 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.

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. We also hold “Shutterfly.com” Internet domain registrations in the United States, Mexico, Australia and New Zealand, and a “Shutterfly and Design” trademark, “Shutterfly Express”, “Shutterfly Collections” “Postcards by Shutterfly”, “Shutterfly Studio”, a “Shutterfly Studio and Design”, “Where your pictures live”, “Your pictures and more”, “NEXO”, and “Make one like this” service mark registrations in the United States. An additional application for the Shutterfly mark is pending in Brazil. We also hold a registration for the “VividPics” service mark in the United States and Brazil, and have pending applications for additional marks, including “Wink”, “Photostrips”, and “Picture More” in the United States. We also own the trademark to our tagline, “Tell Your Story” in the United States.

Government Regulation

The legal environment of the Internet is evolving rapidly in the United States and elsewhere. The manner in which existing laws and regulations will be applied to the Internet in general, and how they will relate to our business in particular, is unclear in many cases. Accordingly, we often cannot be certain how existing laws will apply in the online context, including with respect to such topics as privacy, defamation, pricing, credit card fraud, advertising, taxation, sweepstakes, promotions, content regulation, net neutrality, quality of products and services and intellectual property ownership and infringement. In particular, legal issues relating to the liability of providers of online services for activities of their users are currently unsettled both within the United States and abroad.

Numerous laws have been adopted at the national and state level in the United States that could have an impact on our business. These laws include the following:

- The CAN-SPAM Act of 2003 and similar laws adopted by a number of states. These laws are intended to regulate unsolicited commercial e-mails, create criminal penalties for unmarked sexually-oriented material and e-mails containing fraudulent headers and control other abusive online marketing practices.
- The Communications Decency Act, which gives statutory protection to online service providers who distribute third-party content.
- The Digital Millennium Copyright Act, which is intended to reduce the liability of online service providers for listing or linking to third-party websites that include materials that infringe copyrights or other rights of others.
- The Children’s Online Privacy Protection Act and the Prosecutorial Remedies and Other Tools to End Exploitation of Children Today Act of 2003, which are intended to restrict the distribution of certain materials deemed harmful to children and impose additional restrictions on the ability of online services to collect user information from minors. In addition, the Protection of Children From Sexual Predators Act of 1998 requires online service providers to report evidence of violations of federal child pornography laws under certain circumstances.
- Statutes adopted in the State of California require online services to report certain breaches of the security of personal data, and to report to California consumers when their personal data might be disclosed to direct marketers.

To resolve some of the remaining legal uncertainty, we expect new U.S. and foreign laws and regulations to be adopted over time that will be directly or indirectly applicable to the Internet and to our activities. In addition, government agencies may begin regulating previously unregulated Internet activities or applying existing laws in new ways to providers of online services. Moreover, the law relating to the liability of providers of online services for activities of their users and business partners is currently unsettled both within the United States and abroad. Any existing or new legislation applicable to us could expose us to government investigations or audits, prosecution for violations of applicable laws and/or substantial liability, including penalties, damages, significant attorneys' fees, expenses necessary to comply with such laws and regulations or the need to modify our business practices. For example, in April 2009 we and 21 other e-commerce companies were subpoenaed to provide information related to discount programs offered by three membership program companies, including Webloyalty Inc., one of our business partners. In addition, from time to time claims may be threatened against us for aiding and abetting, defamation, negligence, copyright or trademark infringement, or other theories based on the nature and content of information to which we provide links or that we or others post online. On a more general level, government regulation of the Internet could dampen the growth in the use of the Internet, have the effect of discouraging innovation and investment in Internet-based enterprises or lead to unpredictable litigation.

We post on our website our privacy policies and practices concerning the use and disclosure of user data. Any failure by us to comply with our posted privacy policies, Federal Trade Commission requirements or other privacy-related laws and regulations could result in proceedings that could potentially harm our business, results of operations and financial condition. In this regard, there are a large number of federal and state legislative proposals before the United States Congress and various state legislative bodies regarding privacy issues related to our business. It is not possible to predict whether or when such legislation may be adopted, and certain proposals, such as required use of disclaimers, if adopted, could harm our business through a decrease in user registrations and revenues.

Employees

As of December 31, 2009, we had 519 full time employees. Below is a summary of employees by function:

	2009	2008	2007
Cost of revenue	243	262	204
Technology and development	148	127	115
Sales and marketing	73	70	57
General and administrative	55	55	55
Total	**519**	**514**	**431**

During the peak holiday season, we hire contract workers on a temporary basis from third-party outsourcing firms. For example, during our peak production period in the fourth quarter of 2009, we used approximately 850 temporary workers to assist in our production and fulfillment operations. None of our employees are represented by a labor union or are covered by a collective bargaining agreement. We have never experienced any employment-related work stoppages and consider our employee relations to be good.

Available Information

Our Internet website is located at http://www.shutterfly.com. The information on our website is not a part of this annual report. We make available free of charge on our website our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as soon as reasonably practicable after we electronically file such material with, or furnish it to, the Securities and Exchange Commission. Our SEC reports can be accessed through the investor relations section of our Internet website.

The public may also read and copy any materials we file with the Securities and Exchange Commission at the Securities and Exchange Commission's Public Reference Room at 100 F Street, NE, Washington, DC 20549.

The public may obtain information on the operation of the Public Reference Room by calling the Securities and Exchange Commission at 1-800-SEC-0330. The Securities and Exchange Commission also maintains an Internet website that contains reports, proxy and information statements and other information regarding issuers that file electronically with the Securities and Exchange Commission. The Securities and Exchange Commission's Internet website is located at http://www.sec.gov.

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 more than 50% of our net revenues for 2009 in the fourth quarter of 2009, and the net income that we generated during the fourth quarter of 2009 was necessary for us to achieve profitability on an annual basis. In addition, we incur significant additional expenses in the period leading up to the fourth quarter holiday season including expenses related to the hiring and training of temporary workers to meet our seasonal needs, additional inventory and equipment purchases and increased advertising. If we are unable to accurately forecast and respond to consumer demand for our products during the fourth quarter, our financial results, reputation and brand will suffer and the market price of our common stock would likely decline.

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

In addition, our operations and financial performance depend on general economic conditions. The U.S. economy continues to experience slow economic activity, concerns about inflation, decreased consumer confidence, higher unemployment rates and other adverse business conditions. Such fluctuations in the U.S. economy could cause, among others, prolonged decline in consumer spending and increase in the cost of labor and materials. These conditions could exacerbate variability in our forecasting and could negatively affect our results of operations.

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

Economic trends could adversely affect our financial performance.

We are subject to macro-economic fluctuations in the U.S. economy. Macro-economic issues involving the broader financial markets, including the housing and credit system and the liquidity issues in the auction rate securities that we have invested in have negatively impacted the economy and our financial performance.

Weak economic conditions and declines in consumer spending and consumption may harm our operating results. Purchases of our products are often discretionary. If the economic climate does not improve, customers or potential customers could delay, reduce or forego their purchases of our products and services, which could impact our business in a number of ways, including lower prices for our products and services and reduced sales. In addition, the current economic conditions may lead to price increases by our suppliers or increase our operating expenses due to, among others, higher costs of labor, energy, equipment and facilities. A prolonged economic downturn or slow economic recovery may also lead to additional restructuring actions and associated expenses. For example, during the first quarter of 2009, we reduced our headcount by 5%. Due to reduced consumer spending and increased competitive pressures in the current economic environment, we may not be able to pass these increased costs on to our customers. The resulting increased expenses and/or reduced income would negatively impact our operating results.

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

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

We believe that we must continue to grow our current production capability to meet our projected net revenue targets. We anticipate that total 2010 capital expenditures will range between 7% to 9% of 2010 net revenues. During 2007, we opened a new manufacturing and production facility in Charlotte, North Carolina. In January 2009 we closed our Hayward, California production facility. In April 2009, we opened a new manufacturing and production facility in Phoenix, Arizona. Operational difficulties, such as a significant interruption in the operation of any of our plants could delay production or shipment of our products. Our inability to meet our production requirements could lead to customer dissatisfaction and damage our reputation and brand, which would result in reduced net revenues. Moreover, if the costs of meeting production requirements, including capital expenditures, were to exceed our expectations, our results of operations would be harmed.

In addition, we face significant production risks at peak holiday seasons, including the risks of obtaining sufficient qualified seasonal production personnel. A majority of our workforce during the fourth quarter of 2009 was seasonal, temporary personnel. We have had difficulties in the past finding a sufficient number of qualified seasonal employees, and our failure to obtain qualified seasonal production personnel at any of our production facilities could harm our operations.

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

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

- general economic conditions, including recession and slow economic growth in the U.S. and worldwide and higher inflation, as well as those economic conditions specific to the Internet and e-commerce industries;
- demand for our products and services, including seasonal demand;
- our pricing and marketing strategies and those of our competitors;
- our ability to attract visitors to our website and convert those visitors into customers;
- our ability to retain customers and encourage repeat purchases;
- our ability to sustain our profit margins, and our ability to diversify our product offerings, promote our new products and services and sell to consumers photo-based products such as photo books, calendars and cards;
- the costs of customer acquisition;
- our ability to manage our production and fulfillment operations;
- the costs to produce our prints and photo-based products and merchandise and to provide our services;
- the costs of expanding or enhancing our technology or website;

- a significant increase in returns and credits, beyond our estimated allowances, for customers who are not satisfied with our products;
- declines or disruptions to the travel industry;
- variations in weather, particularly heavy rain and snow which tend to depress travel and picture taking;
- the timing of holidays;
- volatility in our stock price, which may lead to higher stock-based compensation expense;
- consumer preferences for digital photography services;
- improvements to the quality, cost and convenience of desktop printing of digital pictures and products; and
- global and geopolitical events with indirect economic effects such as pandemic disease, war, threat of war or terrorist actions.

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

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

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

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

To address the risks and uncertainties of increasing our market share and growing our business, we must do the following:

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

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

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

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

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

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

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

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

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

We have website operations, offices and customer support centers in Redwood City, California, and production facilities in Charlotte, North Carolina and Phoenix, Arizona. Our growth has placed, and will continue to place, a strain on our administrative and operational infrastructure. Our ability to manage our operations and growth will require us to continue to refine our operational, financial and management controls, human resource policies and reporting systems.

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

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

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

Changes in our pricing strategies have had, and may continue to have, a significant impact on our net revenues and net income. From time to time, we have made changes to our pricing structure, specifically for 4x6 prints, in order to remain competitive. Like 4x6 prints, many of our other products are also offered by our competitors. If in the future, due to competitor activities or other marketing strategies, we significantly reduce our prices on our products without a corresponding increase in volume, it would negatively impact our net revenues and could adversely affect our gross margins and overall profitability.

We generate a significant portion of our net revenues from the fees we collect from shipping our products. For example, these fees represented approximately 14%, 17% and 19% of our net revenues in 2009, 2008 and 2007 respectively. We offer discounted or free shipping, with a minimum purchase requirement, during promotional periods to attract and retain customers. If free shipping offers extend beyond a limited number of occasions, are not based upon a minimum purchase requirement or become commonplace, our net revenues and results of operations would be negatively impacted. In addition, we occasionally offer free or discounted products and services to attract and retain customers. In the future, if we increase these offers to respond to actions taken by our competitors, our results of operations may be harmed.

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

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

- Online digital photography services companies such as Kodak EasyShare Gallery (formerly known as Ofoto), Snapfish, which is a service of Hewlett-Packard, American Greetings' Photoworks and Webshots brands, Vista Print, and others;
- "Big Box" retailers such as Wal-Mart, Costco and others that are seeking to offer low cost digital photography products and services, such as in-store fulfillment and self-service kiosks for printing; these competitors may, among other strategies, offer their customers heavily discounted in-store products and services that compete directly with our offerings;
- Drug stores such as Walgreens, CVS and others that offer in-store pick-up from Internet orders;
- Regional photography companies such as Ritz Camera that have established brands and customer bases in existing photography markets;
- Internet portals and search engines such as Yahoo!, AOL, and Google that offer broad-reaching digital photography and related products and services to their large user bases;
- Home printing service providers such as Hewlett-Packard, Epson, Canon, and Kodak that are seeking to expand their printer and ink businesses by gaining market share in the emerging digital photography marketplace;
- Photo-related software companies such as Apple, Microsoft and Corel;

- Social media companies that host images such as MySpace, Facebook and Hi5; and
- Specialized companies in the photo book and stationery business such as Hallmark, American Greetings, Tiny Prints, Minted, Picaboo and Blurb.

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

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

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

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

At December 31, 2009, we held approximately $47.9 million par value of variable rate debt obligations with a fair value of approximately $41.7 million, classified as short-term investments, with an auction reset feature ("Auction Rate Securities") whose underlying assets are student loans which are substantially backed by the federal government. Since February 2008, these auctions have failed. Therefore our Auction Rate Securities continue to be illiquid and we will not be able to access these funds until a future auction of these investments is successful or a buyer is found outside of the auction process.

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

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

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

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

In order to attract and retain key personnel, we plan to increase our equity pool and may need to grant inducement equity awards outside of our equity pool, which would dilute the ownership of our existing stockholders.

In 2006, the Board authorized three automatic annual increases to our equity pool. Each annual increase is limited to a) 4.62% of common stock issued and outstanding on the December 31 immediately prior to the date of increase or b) a lesser number as determined by the Board. This provision expired after the last annual increase in January 2010, and we intend to propose to our stockholders at the 2010 annual meeting to approve an increase in the number of shares in our equity pool. In addition, in order to attract key personnel, the Board authorized 380,000, 135,100 and 200,000 additional inducement stock option grants and restricted stock awards to supplement our equity pool, which were granted in 2007, 2008 and 2009, respectively. Inducement stock options and awards are granted to certain employees upon hire and do not require shareholder approval. In the future, attracting key personnel may require a level of option grants in excess of the amount available in our equity pool. Moreover, if our stockholders reject an increase to our equity pool, we may need to make more inducement equity grants outside of our equity pool. An increase in our equity pool and grants of awards from it as well as further inducement equity awards outside of our equity pool will cause dilution to our stockholders.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

We have historically relied on an exclusive supply relationship with Fuji Photo Film U.S.A. to supply all of our photographic paper for silver halide print production, such as 4x6 prints. We have an agreement with Fuji that expires in April 2010. If that agreement is not renewed before it expires, or if Fuji fails to perform in accordance with the terms of our agreement and if we are unable to secure a paper supply from a different source in a timely manner, we would likely fail to meet customer expectations, which could result in negative publicity, damage our reputation and brand and harm our business and results of operations. We purchase other photo-based supplies from third parties on a purchase order basis, and, as a result, these parties could increase their prices, reallocate supply to others, including our competitors, or choose to terminate their relationship with us. In addition, we purchase or rent a majority of the machines used to produce certain of our photo-based products from Hewlett-Packard, which is one of our primary competitors in the area of online digital photography services. This competition may influence their willingness to provide us with additional products or services. If we were required to switch vendors of machines for photo-based products, we may incur delays and incremental costs, which could harm our operating results.

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

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

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

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

A key component of our business strategy includes strengthening our competitive position and refining the customer experience on our website through internal development. However, from time to time, we may selectively pursue acquisitions of businesses, such as our 2008 acquisition of Nexo and our September 2009 acquisition of TinyPictures. Integrating any newly acquired businesses, technologies or services is likely to be expensive and time consuming. To finance any acquisition, it may be necessary for us to raise additional funds through public or private financings. Additional funds may not be available on terms that are favorable to us, and, in the case of equity financings, would result in dilution to our stockholders. Also, the value of our stock may be insufficient to attract acquisition candidates. If we do complete any acquisitions, we may be unable to operate the acquired businesses profitably or otherwise implement our strategy successfully. If we are unable to integrate any newly acquired entities, technologies or services effectively, our business and results of operations will suffer. The time and expense associated with finding suitable and compatible businesses, technologies or services could also disrupt our ongoing business and divert our management's attention. Future acquisitions by us could also result in large and immediate write-offs or assumptions of debt and contingent liabilities, any of which could substantially harm our business and results of operations.

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

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

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

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

As of December 31, 2009, we had 35 patents issued and more than 20 patent applications pending in the United States. We intend to pursue corresponding patent coverage in other countries to the extent we believe such coverage is appropriate and cost efficient. We cannot ensure that any of our pending applications will be granted. In addition, third parties have in the past and could in the future bring infringement, invalidity, co-inventorship or similar claims with respect to any of our currently issued patents or any patents that may be issued to us in the future. Any such claims, whether or not successful, could be extremely costly to defend, divert management's time and attention, damage our reputation and brand and substantially harm our business and results of operations.

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

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

Third parties may sue us for infringing their intellectual property rights. In May 2009, we settled a patent infringement suit with Parallel Networks. In August 2009, we settled a patent infringement suit with FotoMedia Technologies, LLC. In December 2009, we settled a patent infringement case with Soverain Software LLC. Likewise, we may need to resort to litigation to enforce our intellectual property rights or to determine the scope and validity of third-party proprietary rights.

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

Alternatively, we may be required to, or decide to, enter into a license with a third party. Any future license required under any other party's patents may not be made available on commercially acceptable terms, if at all. In addition, such licenses are likely to be non-exclusive and, therefore, our competitors may have access to the same technology licensed to us. If we fail to obtain a required license and are unable to design around a patent, we may be unable to effectively conduct certain of our business activities, which could limit our ability to generate revenues and harm our results of operations and possibly prevent us from generating revenues sufficient to sustain our operations.

Various governmental legal proceedings, investigations or audits may adversely affect our business and financial performance.

We may be subject to investigations or audits by governmental authorities and regulatory agencies, which can occur in the ordinary course of business or which can result from increased scrutiny from a particular agency towards an industry, country or practice. For example, in April 2009 we and 21 other e-commerce companies were subpoenaed to provide information related to discount programs offered by three membership program companies, including Webloyalty Inc., one of our business partners. The resolution of such legal proceedings, investigations or audits could require us to pay substantial amounts of money or take actions that adversely affect our operations. In addition, defending against these claims may involve significant time and expense. Given the visibility of our brand we may regularly be involved in legal proceedings, investigations or audits that could adversely affect our business and financial performance.

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

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

We collect sales and use taxes in jurisdictions where we have employees and/or property and in other states where we have implemented joint sales efforts with Target Corporation.

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

Our effective tax rate may be subject to fluctuation from federal and state audits, and stock-based compensation activity.

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

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

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

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

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

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

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

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

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

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

In addition, contractors that we hire as well as other employees have access to confidential information, including credit card data. Although we take steps to limit this access, this data could be compromised by these contractors or other employee personnel. 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 and use of confidential information could damage our reputation and brand and substantially harm our business and results of operations.

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

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

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

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

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

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

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

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

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.

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

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

For example, since 2006 we have licensed software from a third-party to automate the administration of our employee equity programs and calculate our stock-based compensation expense. The third-party published a technical bulletin that identified a change to its most current software version to correct computational errors in determining stock-based compensation expense. In October 2009, we identified that the version of the software we used to calculate stock-based compensation contained the same error and that we had incorrectly calculated stock-based compensation expense. We concluded that it was necessary to restate certain previously issued financial statements for errors in the amount of stock-based compensation recorded. As a result of identifying the error, we restated our financial statements for the years ended December 31, 2007 and 2008, to record additional stock-based compensation expense of approximately $0.7 million in 2007 and $1.1 million in 2008.

If our internal controls are not effective, there may be errors in our financial information that could require a restatement or delay our SEC filings, and investors may lose confidence in our reported financial information, which could lead to a decline in our stock price.

In October 2009, in connection with the restatement of our financial statements related to our accounting for stock-based compensation expense, we determined that we had a material weakness in our internal controls, which pertained to controls to ensure the completeness and accuracy of stock-based compensation expense. This weakness resulted in the restatement of our consolidated balance sheets at December 31, 2008 and December 31, 2007, and our consolidated statements of operations, stockholders' equity and cash flows for the fiscal years ended December 31, 2008 and December 31, 2007, and the related notes thereto to correct an error in our stock-based compensation expense.

It is possible that we may discover other significant deficiencies or material weaknesses in our internal control over financial reporting in the future. Any failure to maintain or implement required new or improved controls, or any difficulties we encounter in their implementation, could cause us to fail to meet our periodic reporting obligations, or result in material misstatements in our financial information. Any such delays or restatements could cause investors to lose confidence in our reported financial information and lead to a decline in our stock price.

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

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

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

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

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.

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

The market price of our common stock may fluctuate significantly in response to numerous factors, many of which are beyond our control. In particular, the stock market as a whole recently has experienced extreme price and volume fluctuations that have affected the market price of many technology companies in ways that may have been unrelated to those companies' operating performance. Factors that could cause our stock price to fluctuate include:

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

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

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

- our board is classified into three classes of directors, each with staggered three-year terms;
- only our chairman, our chief executive officer, our president, or a majority of our board of directors is authorized to call a special meeting of stockholders;
- our stockholders may take action only at a meeting of stockholders and not by written consent;
- vacancies on our board of directors may be filled only by our board of directors and not by stockholders;
- our certificate of incorporation authorizes undesignated preferred stock, the terms of which may be established and shares of which may be issued without stockholder approval; and
- advance notice procedures apply for stockholders to nominate candidates for election as directors or to bring matters before an annual meeting of stockholders.

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

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

ITEM 1B. *UNRESOLVED STAFF COMMENTS.*

Not applicable.

ITEM 2. *PROPERTIES.*

We maintain our corporate headquarters in Redwood City, California in two leased facilities totaling approximately 98,000 square feet. The two buildings are under separate leases that both expire in 2010. In December 2009, we signed a non-binding letter of intent to renew our lease for the two buildings.

We maintain our east-coast production and fulfillment operations in Charlotte, North Carolina in leased facilities totaling approximately 102,400 square feet. The lease for this facility commenced on May 31, 2007, and continues through 2014. We have an option to extend the lease for three additional periods of either three or five years in length, and first rights of refusal to lease space in certain adjacent buildings.

In April 2009, we began operations in a new manufacturing and production facility in Phoenix, Arizona, totaling approximately 101,200 square feet. The lease for this facility commenced in March 2009, and will continue through 2016. We have an option to extend the lease for three additional periods of five years each, and a right of first offer to lease space in adjacent buildings.

We believe that our existing facilities are adequate to meet our current needs.

ITEM 3. *LEGAL PROCEEDINGS.*

On June 25, 2009, Soverain Software LLC filed a complaint for alleged patent infringement against us and seventeen other defendants in *Soverain Software LLC. v J.C.Penny Corp. et.al.,* Civ. No. 6:09-CV-274, in the Eastern District of Texas, Tyler Division. The Complaint asserts infringement of U.S. Patent nos. 5,715,314 and 5,909,492, which claim network sales systems including, among other things, a buyer computer and a shopping cart computer, and U.S. Patent no. 7,272,639, which claims, among other things, a method of processing service requests from a client to a server system through a network using session identifiers. The Complaint asserts that we directly or indirectly infringe the patents without providing any details concerning the alleged infringement, and it seeks unspecified damages and injunctive relief. On December 30, 2009, pursuant to a patent license agreement between the parties dated December 21, 2009, and a Stipulation filed by the parties, the Court dismissed with prejudice Soverain's claims against us and our counterclaims against Soverain.

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

On or about February 5, 2008, Parallel Networks, LLC filed a lawsuit in the United States District Court for the Eastern District of Texas, against us and several other defendants alleging patent infringement. The Parallel Networks complaint seeks unspecified damages, costs, interest and attorneys' fees, and an injunction against all parties. We filed an answer to the complaint on April 29, 2008. On July 14, 2008, we and other defendants filed a motion to stay the lawsuit pending the reexamination of the patents-in-suit by the United States Patent and Trademark Office. On December 23, 2008 that motion was denied. On January 12, 2009, the court entered a revised Agreed Docket Control order setting a schedule for deadlines in the case. The case against us was resolved by settlement and pursuant to a patent license agreement between the parties dated May 5, 2009, the Court dismissed with prejudice Parallel Networks' claims against us on May 18, 2009.

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

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

Not applicable.

PART II

ITEM 5. *MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES.*

Shutterfly's common stock has been traded on the NASDAQ Global Market under the symbol "SFLY" since September 29, 2006. As of February 5, 2010, there were approximately 88 stockholders of record, excluding stockholders whose shares were held in nominee or street name by brokers. We have never paid cash dividends on our capital stock. It is our present policy to retain earnings to finance the growth and development of our business and, therefore, we do not anticipate paying any cash dividends in the foreseeable future. In addition, our current line of credit agreement, which expires in June 2010, prohibits the payment of dividends.

The following table sets forth the high and low sales price per share for Shutterfly's common stock for the periods indicated:

Year Ended December 31, 2008	High	Low
First Quarter	$25.70	$14.65
Second Quarter	$17.83	$12.21
Third Quarter	$12.14	$ 8.59
Fourth Quarter	$ 9.13	$ 5.96

Year Ended December 31, 2009	High	Low
First Quarter	$ 9.92	$ 5.62
Second Quarter	$15.26	$ 9.00
Third Quarter	$18.13	$11.68
Fourth Quarter	$18.82	$13.76

Purchases of Equity Securities of the Issuer and Affiliated Purchasers

Neither we nor any affiliated purchaser repurchased any of our equity securities in the fourth quarter of fiscal year 2009.

ITEM 6. *SELECTED FINANCIAL DATA.*

The consolidated statements of income data for the years ended December 31, 2009, 2008 and 2007 and the consolidated balance sheet data as of December 31, 2009 and 2008 have been derived from our audited consolidated financial statements included elsewhere in this annual report. The consolidated statements of income data for the years ended December 31, 2006 and 2005 and the consolidated balance sheet data as of December 31, 2007, 2006 and 2005 have been derived from our audited consolidated financial statements not included in this annual report. The following selected consolidated financial data should be read in conjunction with our "Management's Discussion and Analysis of Financial Condition and Results of Operations" and consolidated financial statements and related notes to those statements included elsewhere in this annual report.

	Year Ended December 31,				
	2009	2008	2007	2006	2005
	(In thousands, except per share amounts)				
Consolidated Income Statement Data:					
Net revenues	$246,432	$213,480	$186,727	$123,353	$83,902
Cost of net revenues	111,648	96,214	84,111	55,491	36,941
Gross profit	134,784	117,266	102,616	67,862	46,961
Operating expenses:					
Technology and development	46,003	39,707	28,822	19,087	13,152
Sales and marketing	44,870	42,212	33,530	21,940	15,252
General and administrative	35,201	32,741	29,888	19,216	13,657
Total operating expense	126,074	114,660	92,240	60,243	42,061
Income from operations	8,710	2,606	10,376	7,619	4,900
Interest expense	(157)	(273)	(179)	(266)	(367)
Interest and other income, net	814	2,898	5,515	2,387	(103)
Income before income taxes and cumulative effect of change in accounting principle	9,367	5,231	15,712	9,740	4,430
(Provision) / benefit for income taxes	(3,514)	(1,571)	(6,134)	(3,942)	24,060
Net income before cumulative effect of change in accounting principle	5,853	3,660	9,578	5,798	28,490
Cumulative effect of change in accounting principle	—	—	—	—	442
Net income	$ 5,853	$ 3,660	$ 9,578	$ 5,798	$28,932
Net income per share:					
Basic	$ 0.23	$ 0.15	$ 0.39	$ 0.67	$ 1.45
Diluted	$ 0.22	$ 0.14	$ 0.36	$ 0.56	$ 1.02
Weighted average shares					
Basic	25,420	25,036	24,295	8,622	3,255
Diluted	26,810	25,787	26,273	10,331	4,609

The chart above includes the following stock-based compensation amounts:

	Year Ended December 31,				
	2009	2008	2007	2006	2005
	(In thousands)				
Cost of net revenues	$ 416	$ 372	$ 189	$ 96	$ 28
Technology and development	3,340	2,404	1,067	736	826
Sales and marketing	3,577	2,452	1,044	521	239
General and administration	6,940	4,522	2,386	947	2,217
	$14,273	$9,750	$4,686	$2,300	$3,310

Additional notes to selected financial data:

Years ended December 31, 2009, 2008, 2007 and 2006 include stock-based compensation expense under Accounting Standards Codification ("ASC") 718 (formerly Statement of Financial Accounting Standards No. 123(R), *Share-Based Payment*), which requires stock-based compensation expense to be recognized based on the grant date fair value. Periods prior to January 1, 2006 have not been restated to include the compensation charges associated with the provisions of ASC 718.

The year ended December 31, 2005, includes $0.4 million of cumulative effect of a change in accounting principle related to the adoption of ASC 480 (formerly FSP 150-5, *Issuer's Accounting under Statement 150 for Freestanding Warrants and Other Similar Instruments on Shares That Are Redeemable*).

	December 31,				
	2009	**2008**	**2007**	**2006**	**2005**
			(In thousands)		
Consolidated Balance Sheet Data:					
Cash, cash equivalents, and short term investments	$180,737	$ 88,164	$125,584	$119,051	$ 39,153
Property and equipment, net	41,845	48,108	48,416	30,919	20,761
Working capital	141,410	58,232	104,025	102,165	22,687
Total assets	271,313	233,297	208,938	180,160	89,552
Capital lease obligations, less current portion	10	17	107	1,742	3,646
Preferred stock warrant liability	—	—	—	—	1,535
Redeemable convertible preferred stock	—	—	—	—	89,652
Total stockholders' equity (deficit)	215,164	186,802	170,734	151,326	(27,262)

ITEM 7. *MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.*

CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

This document, including the following Management's Discussion and Analysis of Financial Condition and Results of Operations, contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934 that are based upon our current expectations. These forward-looking statements include statements related to our expectations regarding the seasonality of our business, the decline in average selling prices for prints, our capital expenditures for 2010 and the sufficiency of our cash and cash equivalents 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 I, 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 compare these forward-looking statements to actual results.

Overview

We are an Internet-based social expression and personal publishing service that enables consumers to share, print and preserve their memories by leveraging our technology, manufacturing, web-design and merchandising capabilities. Our vision is to make the world a better place by helping people share life's joy. Our mission is to build an unrivaled service that enables deeper, more personal relationships between our customers and those who matter most in their lives. Our primary focus is on helping consumers manage their memories through the powerful medium of photography. We provide a full range of personalized photo-based products and services that make it easy, convenient and fun for consumers to upload, edit, enhance, organize, find, share, create, print and preserve their memories in a creative and thoughtful manner.

We currently generate the majority of our revenues by producing and selling professionally-bound photo books, personalized calendars, greeting cards and stationery, other photo-based merchandise and high-quality prints ranging in size from wallet-sized to jumbo-sized 20x30 enlargements. We currently manufacture these items in our Charlotte, North Carolina and Phoenix, Arizona manufacturing facilities. Our new manufacturing and production facility in Phoenix, Arizona began operations in April 2009, and replaced our Hayward, California facility, which ceased operations in January 2009. By controlling the production process in our own manufacturing facilities, we are able to produce high-quality products, innovate rapidly, maintain a favorable cost structure and ensure timely shipment to customers, even during peak periods of demand. Additionally, we sell a variety of photo-based merchandise that is currently manufactured for us by third parties, such as calendars, mugs, canvas prints, mouse pads, magnets and puzzles. We generate substantially all of our revenue from sales originating in the United States and our sales cycle has historically been highly seasonal as we generate more than 50% of our revenue during our fiscal fourth quarter. During fiscal year 2009, we fulfilled 7.9 million orders, to 3.3 million customers, at an average order value of $30.74 per order.

Our high-quality products and services and the compelling online experience we create for our customers, combined with our focus on continuous innovation, have allowed us to establish a premium brand. We realize the benefits of a premium brand through high customer loyalty, low customer acquisition costs and premium pricing.

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

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

Basis of Presentation

Net Revenues. Our net revenues are comprised of sales generated from personalized products and services ("PPS"), prints and commercial printing services.

Personalized products and services

Our personalized products and services revenues are derived from the sale of photo-based products, such as photo books, greeting and stationery cards, calendars and other photo-based merchandise and ancillary products and services, and the related shipping revenues. Revenue from advertising displayed on our website and referral fees are also included in PPS revenue. Our referral fees have been approximately 3.0%, 3.1% and 2.5% of our net annual revenues for 2007, 2008, and 2009. Our referral fee program will be discontinued effective March 31, 2010. As a result, referral fee revenues during 2010 are expected to total less than 1% of total net revenues and no referral fee revenues are expected subsequent to March 31, 2010.

Prints

We also generate revenue from photo prints and the associated shipping revenue. Photo prints consist of wallet, 4x6, 5x7, 8x10, photocards and large format sizes.

Commercial Print Services

In order to use available print capacity during low volume periods and to leverage our large installed base of existing digital printers, we began providing commercial printing services in 2008. In 2008 and 2009, we entered into various strategic relations with marketing companies to provide high quality printing services. We continue to focus our efforts in expanding our presence in this market.

All of our consumer revenue is recorded net of estimated returns, promotions redeemed by customers and other discounts. Customers place orders through our website and pay primarily using credit cards. Advertising and commercial print customers are invoiced upon fulfillment.

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

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

Total Customers. We closely monitor total customers as a key indicator of demand. Total customers include the number of transacting customers in a given period. We seek to expand our customer base by empowering our existing customers with sharing and collaboration services (such as Shutterfly Gallery and Shutterfly Share Sites), and by conducting integrated marketing and advertising programs. Total customers have increased on an annual basis for each year since inception and while we expect this trend to continue, the number of customers is dependent on whether we are successful in executing our strategy in addition to the conditions of the overall economic environment.

Average Order Value. Average order value is net revenues, excluding revenues from our commercial print initiative, for a given period divided by the total number of customer orders recorded during that same period. We seek to increase average order value as a means of increasing net revenues. Average order value has increased on an annual basis for each year since 2000, and we anticipate that this trend will continue in the future as consumers shift from prints into personalized products and services. As a result of discontinuing our referral fee program, effective March 31, 2010, we expect our average order value growth will moderate as a result of the decline in this revenue source.

Total Number of Orders. We closely monitor total number of orders as a leading indicator of net revenue trends. We recognize the net revenues associated with an order when the products have been shipped and all other revenue recognition criteria have been met. Orders are typically processed and shipped within two business days after a customer places an order. Total number of orders has increased on an annual basis for each year since 2000, and while we anticipate this trend to continue in the future, the number of orders is dependent on whether we are successful in executing our strategy, the conditions of the overall economic environment and a continued increase in consumer trends towards photo-based products.

Personalized Products and Services Revenues as Percentage of Net Revenues. We continue to innovate and improve our personalized products and services and expect the net revenues from these products and services to increase as a percentage of total net revenues as we continue to diversify our product offerings. Personalized products and services as a percentage of total net revenue was 56% in 2007, 61% in 2008 and 66% in 2009.

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

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

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

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

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

General and administrative expense includes general corporate costs, including rent for our corporate offices, insurance, depreciation on information technology equipment and legal and accounting fees. In addition, general and administrative expense includes personnel expenses of employees involved in executive, finance, accounting, human resources, information technology and legal roles. Third-party payment processor and credit card fees are also included in general and administrative expense and have historically fluctuated based on revenues during the period. All of the payments we have received from our intellectual property license agreements have been included as an offset to general and administrative expense. In 2009, we received annual payments from two different cross-licensing agreements. We expect to recognize a final payment due from one of the agreements when it is received in the first quarter of fiscal year 2010.

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

Interest and other income, net. Interest and other income, net consists of the interest earned on our cash and investment accounts as well as gains/losses on our trading securities and the Right from UBS entitling us to sell at par value auction-rate securities previously purchased from UBS (approximately $47.9 million, par value) at anytime during a two-year period from June 30, 2010 through July 2, 2012.

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

Critical Accounting Policies and Estimates

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

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

Revenue Recognition. We generate revenues primarily from the printing and shipping of prints and other photo-based products, advertising services and commercial print services. We generally recognize revenues from product sales upon shipment when persuasive evidence of an arrangement exists (typically through the use of a credit card or receipt of a check), the selling price is fixed or determinable and collection of resulting receivables is reasonably assured. Revenues from amounts billed to customers, including prepaid orders, are deferred until shipment of fulfilled orders.

We provide our customers with a 100% satisfaction guarantee whereby products can be returned within a 30-day period for a reprint or refund. We maintain an allowance for estimated future returns based on historical data. During the year ended December 31, 2009, returns totaled less than 1% of net revenues and have been within management's expectations.

We periodically provide incentive offers to our customers in exchange for setting up an account and to encourage purchases. Such offers include free products and percentage discounts on current purchases. Discounts, when accepted by customers, are treated as a reduction to the purchase price of the related transaction and are included in net revenues. Production costs related to free products are included in costs of revenues upon redemption. Shipping charged to customers is recognized as revenue at the time of shipment.

Our advertising revenues are derived from the sale of online advertisements on our website. Advertising revenues are recognized as "impressions" (i.e., the number of times that an advertisement appears in pages viewed by users of our website) are delivered; as "clicks" (which are generated each time users on our website click through our advertisements to an advertiser's designated website) are provided to advertisers; or ratably over the term of the agreement with the expectation that the advertisement will be delivered ratably over the contract period.

We recognize commercial print revenue upon shipment, consistent with our product revenue policy.

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.

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

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

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

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

We utilized a discounted cash flow approach to determine the Level 3 valuation for our auction rate securities. The assumptions used in preparing the discounted cash flow model include estimates for interest rates, timing and amount of cash flows, credit and liquidity premiums, and expected holding periods of the auction rate securities. These assumptions are volatile and subject to change as the underlying sources of these assumptions and market conditions change. They represent our estimates given available data as of December 31, 2009. We also measure the Rights at fair value, in order to match the changes in the fair value of the auction rate securities.

Goodwill and Intangible Assets. We account for intangible assets and goodwill in accordance with ASC 350 (formerly Statement of Financial Accounting Standards ("SFAS") No. 142, *Goodwill and Other Intangible Assets*). Goodwill and intangible assets with indefinite lives are not amortized but are tested for impairment on an annual basis during our fourth quarter or whenever events or changes in circumstances indicate that the carrying amount of these assets may not be recoverable. Intangible assets with finite useful lives are amortized using the straight-line method over their useful lives and are reviewed for impairment in accordance with ASC 360, (formerly SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*).

Intangible assets are amortized on a straight-line basis over the estimated useful lives which range from one to sixteen years.

For annual goodwill impairment analysis, we operate under one reporting unit. We determined the fair value of our reporting unit based on its enterprise value. This reporting unit was not at risk of failing step one of the annual goodwill impairment test for years ended December 31, 2009 and 2008.

Software and Website Development Costs. We capitalize eligible costs associated with software developed or obtained for internal use in accordance with ASC 350-50 (formerly AICPA Statement of Position No. 98-1 *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use* and EITF Issue No. 00-2 *Accounting for Website Development Costs).* Accordingly, payroll and payroll-related costs and stock-based compensation incurred in the development phase are capitalized and amortized over the product's estimated useful life, which is generally three years. Costs associated with minor enhancements and maintenance for our website are expensed as incurred.

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

We account for uncertain tax positions in accordance with ASC 740-10 (formerly Financial Accounting Standards Board ("FASB") Interpretation No. 48 "*Accounting for Uncertainty in Income Taxes"* an interpretation of SFAS No. 109 "*Accounting for Income Taxes"*). The application of income tax law is inherently complex. Laws and regulations in this area are voluminous and are often ambiguous. We are required to make 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 operations.

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

Stock-Based Compensation Expense. We account for our stock based awards in accordance with ASC 718 (formerly SFAS 123(R) "*Share-Based Payment*"), which requires a fair value measurement and recognition of compensation expense for all share-based payment awards made to our employees and directors, including employee stock options and restricted stock awards.

We estimate the fair value of stock options granted using the Black-Scholes valuation model. This model requires us to make estimates and assumptions including, among other things, estimates regarding the length of time an employee will retain vested stock options before exercising them, the estimated volatility of our common stock price and the number of options that will be forfeited prior to vesting. The fair value is then amortized on a straight-line basis over the requisite service periods of the awards, which is generally the vesting period. Changes in these estimates and assumptions can materially affect the determination of the fair value of stock-based compensation and consequently, the related amount recognized in our consolidated statements of operations.

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

Results of Operations

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

	Year Ended December 31,		
	2009	2008	2007
Net revenues	100%	100%	100%
Cost of revenues	45	45	45
Gross profit	55	55	55
Operating expenses:			
Technology and development	19	19	15
Sales and marketing	18	20	18
General and administrative	14	15	16
Income from operations	4	1	6
Interest expense	0	0	0
Interest and other income, net	0	2	2
Income before income taxes	4	3	8
Provision for income taxes	(1)	(1)	(3)
Net income	3%	2%	5%

Comparison of the Years Ended December 31, 2009 and 2008

	Year Ended December 31,			
	2009	2008	$ Change	% Change
	(In thousands)			
Net revenues	$246,432	$213,480	$32,952	15%
Cost of net revenues	$111,648	$ 96,214	$15,434	16%
Percentage of net revenues	*45%*	*45%*	—	—
Gross profit	$134,784	$117,266	$17,518	15%

Net revenues increased $33.0 million, or 15%, in 2009 compared to 2008. Revenue growth was attributable to an increase in personalized products and services revenues and revenue from our commercial print initiative, offset by a decrease in print revenue. PPS revenues increased $32.1 million, or 25%, to $161.7 million in 2009 compared to 2008. The increase in PPS is primarily a result of increased sales of photo books, stationery cards and calendars. PPS represented 66% of revenue in 2009 compared to 61% in 2008. Revenue from our commercial print initiative totaled $3.8 million for 2009, and represented 1.6% of our total net revenues. Print revenue decreased $2.7 million, or 3%, to $80.9 million from 2008 to 2009. As a percentage of revenue, print revenue declined in 2009, decreasing from 39% in 2008 to 33% in 2009. 4x6 print revenue represented 14% of total net revenues versus 19% in the prior year. The decrease in overall print revenue was primarily due to a lower average sales price for 4x6 prints which is a result of our price change in September 2008, offset partially by continued stable growth in unit volumes.

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

	Year Ended December 31,			
	2009	2008	Change	% Change
	(In thousands, except AOV amounts)			
Customers	3,281	2,789	493	18%
Orders	7,891	7,569	322	4%
Average order value	$30.74	$28.16	$2.58	9%

Cost of net revenues increased $15.4 million, or 16%, in 2009 compared to 2008. As a percentage of net revenues, cost of net revenues remained flat, at 45%, resulting in gross margin percentage remaining flat at 55%. Overall, the increase in cost of net revenues was primarily the result of the increased volume of shipped products, cost increases from the closure and transition of our Hayward manufacturing facility to our new Phoenix manufacturing facility, increased headcount, and higher equipment rental expenses compared to 2008. These costs were partially offset by favorable improvements from product mix, labor efficiencies from both our Charlotte and Phoenix plants and improvements in material costs.

	Year Ended December 31,			
	2009	2008	$ Change	% Change
	(In thousands)			
Technology and development	$46,003	$39,707	$6,296	16%
Percentage of net revenues	*19%*	*19%*	—	—
Sales and marketing	$44,870	$42,212	$2,658	6%
Percentage of net revenues	*18%*	*20%*	—	—
General and administrative	$35,201	$32,741	$2,460	8%
Percentage of net revenues	*14%*	*15%*	—	—

Our technology and development expense increased $6.3 million, or 16%, in 2009 compared to 2008. As a percentage of net revenues, technology and development expense remained flat at 19% in 2009 and 2008. The increase in technology and development expense was primarily due to an increase of $2.7 million in third party hosting, power and connectivity costs compared to the prior year. Depreciation expense increased by $0.5 million as we continued to invest in our website infrastructure hardware to support our continued revenue growth. Personnel and related costs for employees and consultants involved with website development and website infrastructure support teams increased by $2.2 million. In 2009, we capitalized $5.4 million in eligible costs, which includes $1.6 million of stock based compensation, associated with software developed or obtained for internal use, compared to $4.8 million capitalized in 2008.

Our sales and marketing expense increased $2.7 million, or 6%, in 2009 compared to 2008. As a percentage of net revenues, total sales and marketing expense decreased from 20% in 2008 to 18% in 2009. The increase in sales and marketing expense was primarily due to an increase of $1.6 million in personnel and related costs as we expanded our internal marketing team and an increase of $1.1 million in stock based compensation. The increase was offset by a decrease of $0.2 million in customer acquisition costs and affiliate fees due to improved promotional efficiencies and search engine optimization performance.

Our general and administrative expense increased $2.5 million, or 8%, in 2009 compared to 2008, and decreased as a percentage of net revenues from 15% in 2008 to 14% in 2009. Increase in general and administrative expense is primarily due to an increase in stock based compensation of $2.4 million, facility costs of $0.8 million, and personnel related costs of $0.4 million. In 2009, we also incurred an increase in credit card fees of $0.7 million which was driven by our increase in consumer product revenue as compared to the prior year. The overall increase in general and administrative expense was offset by a decrease of $2.0 million associated with decreases in accounting compliance efforts and enterprise resource planning ("ERP") costs. Also, offsetting general and administrative expenses in 2009, are installment payments from two cross-licensing agreements for intellectual property entered into with two different companies. Both agreements require multiple installments with the second installments received during 2009 from both parties. We expect to recognize the final installment pursuant to one of the agreements upon receipt in the first quarter of 2010.

	Year Ended December 31,		
	2009	2008	Change
	(In thousands)		
Interest expense	$(157)	$ (273)	$ (116)
Interest and other income, net	$ 814	$2,898	$(2,084)

Interest expense decreased by $0.1 million for 2009 compared to 2008 primarily due to the expiration of our line of credit with JP Morgan in April 2009. We completed our replacement facility with Silicon Valley Bank on June 29, 2009 and incurred lower origination costs resulting in a decrease in amortization expense as compared to the prior year.

Interest and other income, net decreased by $2.1 million for 2009 compared to 2008, primarily as a result of an overall lower yield on our investment portfolio, including our auction rate securities, relative to our investment balances in 2008. In 2009, we recorded a $2.7 million mark-to-market gain on our auction-rate securities that have been classified as trading securities which was entirely offset by a $2.7 million loss on the UBS Right.

	Year Ended December 31,	
	2009	2008
	(In thousands)	
Income tax provision	$(3,514)	$(1,571)
Effective tax rate	38%	30%

The provision for income taxes was $3.5 million for 2009, compared to a provision of $1.6 million for 2008. Our effective tax rate was 38% in 2009, up from 30% in 2008. This increase in our effective tax rate is primarily the result of lower research and development tax credits recorded in 2009, as compared to 2008.

At December 31, 2009, we had approximately $32.7 million of state net operating loss carryforwards to reduce future regular taxable income. These carryforwards will expire beginning in 2014 through 2016, if not utilized. We recognized the remaining federal net operating loss carryforward in 2009, except for federal net operating losses associated with our acquisition of TinyPictures in the amount of $1.7 million. We will begin accruing current cash taxes payable for federal purposes in 2010.

	Year Ended December 31,			
	2009	2008	$ Change	% Change
	(In thousands)			
Income before income taxes	$9,367	$5,231	$4,136	79%
Net income	$5,853	$3,660	$2,193	60%
Percentage of net revenues	3%	2%	—	—

Net income increased by $2.2 million, or 60%, from 2008 to 2009. As a percentage of net revenue, net income was 3% of net revenue for 2009 compared to 2% for 2008.

Comparison of the Years Ended December 31, 2008 and 2007

	Year Ended December 31,			
	2008	2007	$ Change	% Change
	(In thousands)			
Net revenues	$213,480	$186,727	$26,753	14%
Cost of net revenues	$ 96,214	$ 84,111	$12,103	14%
Percentage of net revenues	*45%*	*45%*	—	—
Gross profit	$117,266	$102,616	$14,650	14%

Net revenues increased $26.8 million, or 14%, in 2008 compared to 2007. Revenue growth was primarily attributable to the increases in personalized products and services revenues. PPS revenues increased $24.6 million, or 23%, to $129.9 million from 2007 to 2008 representing 61% of total revenues in 2008, up from 56% in 2007. There was increased revenue across our entire PPS product base, and most significantly through increased sales of photo books and calendars. Print revenues increased $2.2 million, or 3%, to $83.6 million from 2007 to 2008. As a percentage of total net revenue, 4x6 print revenues declined in 2008, decreasing from 22% in 2007 to 19% in 2008. During the third quarter of 2008, we made a permanent price adjustment on 4x6 prints, lowering the list price from $0.19 to $0.15 and we also reduced the lowest tier in our prepaid plan to $0.10. Net revenue increases were also the result of year-over-year increases in customers, orders and average order value ("AOV"). AOV improvement was a result of a continued mix shift from prints to higher value personalized products, particularly photo books.

	Year Ended December 31,			
	2008	2007	Change	% Change
	(In thousands, except AOV amounts)			
Customers	2,789	2,357	432	18%
Orders	7,569	7,062	507	7%
Average order value	$28.20	$26.44	$1.76	7%

Cost of net revenues increased $12.1 million, or 14%, in 2008 compared to 2007. As a percentage of net revenues, cost of net revenues remained flat, at 45%. Overall, the increase in cost of net revenues was primarily the result of the increased volume of shipped products, fixed costs associated with operating two manufacturing facilities in the first two quarters of 2008, versus one facility in 2007, and the impact of intangible asset amortization from the Nexo acquisition which was not incurred in the year ended December 31, 2007. In addition, we incurred approximately $0.5 million in accelerated leasehold improvement amortization and $0.6 million in employee severance costs associated with the closure of our Hayward manufacturing facility which was announced in the third quarter of 2008. These costs were offset in part by savings in labor, shipping, and materials costs reflecting efficiencies realized in our Charlotte facility, and other negotiated cost reductions.

	Year Ended December 31,			
	2008	2007	$ Change	% Change
	(In thousands)			
Technology and development	$39,707	$28,822	$10,885	38%
Percentage of net revenues	*19%*	*15%*	—	—
Sales and marketing	$42,212	$33,530	$ 8,682	26%
Percentage of net revenues	*20%*	*18%*	—	—
General and administrative	$32,741	$29,888	$ 2,853	10%
Percentage of net revenues	*15%*	*16%*	—	—

Our technology and development expense increased $10.9 million, or 38%, in 2008 compared to 2007. As a percentage of net revenues, technology and development expense increased from 15% in 2007 to 19% in 2008. The overall increase in technology and development expense was attributable to increased personnel and related costs for employees and consultants involved with website development and website infrastructure support teams, which totaled $3.7 million. Depreciation expense also increased by $3.7 million as we continued to invest in our website infrastructure hardware to support our continued revenue growth. Stock-based compensation expense increased by $1.3 million in 2008 compared to 2007. Facility related costs increased by $2.3 million compared to 2007, due to our expansion to a new colocation hosting site which resulted in higher networking, power and storage costs during fiscal year 2008. And, in 2008, we capitalized $4.8 million in eligible website development costs compared to $3.1 million in 2007.

Our sales and marketing expense increased $8.7 million, or 26%, in 2008 compared to 2007. Also as a percentage of net revenues, total sales and marketing expense increased from 18% in 2007 to 20% in 2008. In 2008, we expanded our online media and direct response marketing campaigns and incurred increased agency fees for creative and branding promotions which represented a $5.0 million increase compared to 2007. We also expanded our internal marketing team resulting in an increase in personnel and related costs of $2.2 million. In addition, stock-based compensation expense increased $1.5 million to $2.5 million in 2008, compared to $1.0 million in 2007.

Our general and administrative expense increased $2.9 million, or 10%, in 2008 compared to 2007, and decreased as a percentage of net revenues from 16% in 2007 to 15% in 2008. Personnel and related costs increased by $2.0 million in 2008, reflecting increased hiring. Stock based compensation also increased by $2.1 million compared to 2007. Office related costs increased by $1.1 million compared to 2007, as we expanded our corporate office space during 2008. Offsetting general and administrative expenses in 2008, are installment payments from two multi-million dollar cross-licensing agreements for intellectual property entered into with two different companies. Both agreements require multiple installments with the first installments received during 2008 from both parties. We expect to recognize the remaining installments under the agreements as the amounts are received on the scheduled due dates. In addition, fees to consultants and contractors decreased by approximately $1.0 million due primarily to efficiencies from our Sarbanes-Oxley compliance efforts. In 2008, we capitalized $1.3 million in internally developed software related to our newly implemented enterprise resource planning system.

	Year Ended December 31,		
	2008	2007	Change
	(In thousands)		
Interest Expense	$ (273)	$ (179)	$ (94)
Interest and other income, net	$2,898	$5,515	$(2,617)

Interest expense increased by $94,000 for 2008 primarily due to amortization associated with the line of credit origination costs.

Interest and other income, net decreased by $2.6 million for 2008, primarily as a result of an overall lower yield on our investment portfolio, including our auction rate securities, relative to our investment balances in 2007.

	Year Ended December 31,	
	2008	2007
	(In thousands)	
Income tax provision	$(1,571)	$(6,134)
Effective tax rate	30%	39%

The provision for income taxes was $1.6 million for 2008, compared to a provision of $6.1 million for 2007. Our effective tax rate was 30% in 2008, down from 39% in 2007. This decrease in our effective tax rate is primarily the result of additional tax credits related to our research and development activity from 2007.

As of December 31, 2008, we had approximately $12.1 million of federal and $32 million of state net operating loss carryforwards available to reduce future taxable income. These net operating loss carryforwards begin to expire in 2021 and 2014 for federal and state tax purposes, respectively.

	Year Ended December 31,			
	2008	2007	$ Change	% Change
	(In thousands)			
Income before income taxes	$5,231	$15,712	$(10,481)	(67)%
Net income	$3,660	$ 9,578	$ (5,918)	(62)%
Percentage of net revenues	*2%*	*5%*	—	—

Net income decreased by $6.0 million, or 62%, for 2008 as compared to 2007. As a percentage of net revenue, net income was 2% of net revenue for 2008 compared to 5% for 2007.

Liquidity and Capital Resources

Our total capital resources were as follows (in thousands):

	December 31,	
	2009	2008
Cash and cash equivalents	$132,812	$ 88,164
Auction Rate Securities and Rights	47,925	52,250
Total Capital Resources	$180,737	$140,414

As of December 31, 2009, we had access to cash and cash equivalents, totaling $132.8 million. In addition, to supplement our overall liquidity position, we have a 360-day revolving credit facility with a financial institution to provide up to $20.0 million in additional capital resources that expires in June 2010. As of December 31, 2009, no amounts have been drawn against this facility.

At December 31, 2009, we held approximately $47.9 million par value of variable rate bond investments with a fair value of approximately $41.7 million, classified as short-term investments, with an auction reset feature (“auction rate securities” or “ARS”) whose underlying assets are student loans which are substantially backed by the federal government. Since February 2008, these auctions have failed. Therefore the ARS continue to be illiquid and we will not be able to access these funds until a future auction of these investments is successful or a buyer is found outside of the auction process.

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

Due to the adverse conditions in the auction rate securities market, we have used a level 3 discounted cash flow valuation model to value the ARS investments and the Right. We believe there are several significant assumptions that are utilized in our ARS valuation analysis, the two most critical of which are the discount rate and the average expected term. Holding all other factors constant, if we were to increase the discount rate utilized in our valuation analysis by 50 basis points, or one-half of a percentage point, this change would have the effect of reducing the fair value of our ARS by approximately $0.9 million as of December 31, 2009. Similarly, holding all other factors constant, if we were to increase the average expected term utilized in our fair value calculation by one year, this change would have the effect of reducing the fair value of our ARS by approximately

$1.1 million as of December 31, 2009. We also consider credit ratings with respect to our investments provided by investment ratings agencies. As of December 31, 2009, all of our investments conformed to the requirements of our investment policy, which requires that all of our investments meet high credit quality standards as defined by credit ratings of the major investment ratings agencies. These ratings are subject to change and a downgrade in rating would adversely affect the value of our investments.

Although these investments continue to be illiquid, during 2009 we liquidated $4.3 million (at par value) ARS investments that were called by the state issuers.

Non-GAAP Financial Measures

Regulation G, conditions for use of Non-Generally Accepted Accounting Principles ("Non-GAAP") financial measures, and other SEC regulations define and prescribe the conditions for use of certain Non-GAAP financial information. We closely monitor two financial measures, adjusted EBITDA and free cash flow which meet the definition of Non-GAAP financial measures. We define adjusted EBITDA as earnings before interest, taxes, depreciation, amortization and stock-based compensation. Free cash flow is defined as adjusted EBITDA less purchases of property and equipment and capitalization of software and website development costs. Management believes these Non-GAAP financial measures reflect an additional way of viewing our liquidity that, when viewed with our GAAP results, provides a more complete understanding of factors and trends affecting our cash flows. Refer below for a reconciliation of both adjusted EBITDA and free cash flow to the most applicable GAAP measure.

To supplement our consolidated financial statements presented on a GAAP basis, we believe that these Non-GAAP measures provide useful information about our core operating results and thus are appropriate to enhance the overall understanding of our past financial performance and our prospects for the future. These adjustments to our GAAP results are made with the intent of providing both management and investors a more complete understanding of our underlying operational results and trends and performance. Management uses these Non-GAAP measures to evaluate our financial results, develop budgets, manage expenditures, and determine employee compensation. The presentation of additional information is not meant to be considered in isolation or as a substitute for or superior to net income (loss) or net income (loss) per share determined in accordance with GAAP. Management strongly encourages shareholders to review our financial statements and publicly-filed reports in their entirety and not to rely on any single financial measure.

The table below shows the trend of adjusted EBITDA and free cash flow as a percentage of revenue over fiscal years 2009, 2008, and 2007 (in thousands):

	Year Ended December 31,		
	2009	**2008**	**2007**
Revenue	$246,432	$213,480	$186,727
Non-GAAP Adjusted EBITDA	50,177	38,394	32,858
EBITDA % of Revenue	*20%*	*18%*	*18%*
Free cash flow	32,522	15,647	(2,135)
Free cash flow % of Revenue	*13%*	*7%*	*-1%*

By carefully managing our operating costs and capital expenditures, we were able to make the strategic investments necessary to grow and strengthen our business, while at the same time increasing our adjusted EBITDA profitability and substantially improving our free cash flows. Our full year adjusted EBITDA profitability rate improved from 18% in 2008 to 20% in 2009. Our capital expenditures have decreased from 2007 to 2009 as we continue to make strategic capital investments that are necessary to support our overall growth as a business, improve efficiencies in our production and satisfy our customer needs while improving our cost imperatives. As a result, our free cash flow during 2009 was $32.5 million compared to $15.6 million in 2008.

Free cash flow has limitations due to the fact that it does not represent the residual cash flow for discretionary expenditures. For example, free cash flow does not incorporate payments made on capital lease obligations or cash requirements to comply with debt covenants. Therefore, we believe that it is important to view free cash flow as a compliment to our consolidated financial statements as reported.

The following is a reconciliation of adjusted EBITDA and free cash flow to the most comparable GAAP measure, Net Income for the years ended December 31, 2009, 2008 and 2007 (in thousands):

Reconciliation of Non-GAAP Adjusted EBITDA	**Year Ended December 31,**		
	2009	**2008**	**2007**
Net Income	$ 5,853	$ 3,660	$ 9,578
Add back:			
Interest expense	157	273	179
Interest and other income, net	(814)	(2,898)	(5,515)
Tax provision	3,514	1,571	6,134
Depreciation and amortization	27,194	26,038	17,796
Stock-based compensation expense	14,273	9,750	4,686
Non-GAAP Adjusted EBITDA	$50,177	$38,394	$32,858

Reconciliation of Non-GAAP Adjusted EBITDA to Free Cash Flow	**Year Ended December 31,**		
	2009	**2008**	**2007**
Non-GAAP Adjusted EBITDA	$ 50,177	$ 38,394	$ 32,858
Less: Purchases of property and equipment, including accrual amounts	(13,764)	(18,220)	(31,881)
Less: Capitalized technology & development costs	(3,891)	(4,527)	(3,112)
Free cash flow	$ 32,522	$ 15,647	$ (2,135)

Below is our cash flow activity for the years ended December 31, 2009, 2008 and 2007:

	Year Ended December 31,		
	2009	**2008**	**2007**
		(In thousands)	
Consolidated Statement of Cash Flows Data:			
Purchases of property and equipment	$ 13,762	$ 18,220	$ 31,881
Capitalization of software and website development costs	3,891	4,527	3,112
Acquisition of business and intangibles, net of cash acquired	795	10,097	2,858
Depreciation and amortization	27,194	26,038	17,796
Cash flows from operating activities	53,890	47,040	42,192
Cash flows used in investing activities	(14,123)	(82,086)	(40,823)
Cash flows from financing activities	4,881	628	2,162

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

We anticipate that total 2010 capital expenditures will range between 7% to 9% of our expected net revenues in 2010. These expenditures will be used to purchase technology and equipment to support the growth in our business and to increase our production capacity and help enable us to respond more quickly and efficiently to customer demand. Our expenditures also include costs associated with capitalized software and website development. This range of capital expenditures is not outside the ordinary course of our business or materially different from how we have expanded our business in the past.

Operating Activities. For 2009, net cash provided by operating activities was $53.9 million, primarily due to our net income of $5.9 million and the net change in operating assets and liabilities of $7.4 million, adjusted for non-cash items including $27.2 million of depreciation and amortization expense, $2.9 million benefit from deferred income taxes, $1.7 million for tax benefit from stock-based compensation, and $14.3 million of stock-based compensation.

For 2008, net cash provided by operating activities was $47.0 million, primarily due to our net income of $3.7 million and the net change in operating assets and liabilities of $8.0 million, adjusted for non-cash items including $26.0 million of depreciation and amortization expense, $0.7 million benefit from deferred income taxes, $0.4 million for tax benefit from stock-based compensation, and $9.8 million of stock-based compensation.

For 2007, net cash provided by operating activities was $42.2 million, primarily due to our net income of $9.6 million and the net change in operating assets and liabilities of $4.2 million, adjusted for non-cash items including $17.8 million of depreciation and amortization expense, $5.7 million of provision for deferred income taxes, and $4.7 million of stock-based compensation.

Investing Activities. For 2009, net cash used in investing activities was $14.1 million, which included $13.8 million for capital expenditures for computer and network hardware for our website infrastructure and information technology systems, capital expenditures for production equipment for our manufacturing and production operations, and $3.9 million of capitalized software and website development. We also paid $0.8 million in cash to acquire TinyPictures, Inc. The use of cash was offset by cash provided from the liquidation of $4.3 million (at par value) of our ARS investments that were called by various issuers at par.

For 2008, net cash used in investing activities was $82.1 million, which included $18.2 million for capital expenditures for computer and network hardware for our website infrastructure and information technology systems, capital expenditures for production equipment for our manufacturing and production operations at our California and North Carolina facilities, and $4.5 million of capitalized software and website development. An additional $52.3 million was used to purchase auction rate securities, offset by $3.0 million in proceeds from the sale of the short term investments. We also paid $10.1 million in cash consideration to acquire Nexo.

For 2007, net cash used in investing activities included $31.9 million for capital expenditures for computer and network hardware for our website infrastructure and information technology systems, capital expenditures for production equipment for our manufacturing and production operations at our California and North Carolina facilities, and $3.1 million of capitalized website development costs. Additional cash of $3.0 million was used for purchases of short-term investments and $2.9 million was used for the acquisition of "Make-it-About-Me," and a customer list.

Financing Activities. For 2009, net cash provided by financing activities was $4.9 million, primarily from $3.3 million excess tax benefit from stock-options and $2.7 million of proceeds from issuance of common stock from exercise of stock options, offset by $91,000 principal payments of capital lease obligations and $1.0 million in cash used to pay employee withholding tax liabilities for restricted shares vested during 2009.

Our financing activities for 2008 provided cash of $0.6 million, primarily from $1.2 million of proceeds from issuance of common stock from exercise of stock options and $0.5 million excess tax benefit from stock options, offset by $0.8 million principal payments of capital lease obligations and shares withheld to pay for employee's withholding tax liability for restricted awards vested of $0.3 million.

Our financing activities for 2007 provided cash of $2.2 million, primarily from $5.0 million of proceeds from issuance of common stock, offset by $2.8 million of capitalized lease obligations.

Contractual Obligations

We lease office space in Redwood City, California and a production facility in Charlotte, North Carolina under non-cancelable operating leases that expire in 2010 and 2014, respectively. In 2008, we terminated the lease at our Hayward, California facility effective June 2009, which was originally scheduled to expire in September 2009. In 2008, we entered into a non-cancelable operating lease for our new Phoenix, Arizona facility that commenced in February 2009 and will expire in 2016. We lease information technology equipment under various capital leases that expire through 2011. We also have co-location agreements with third-party hosting facilities that expire in 2013. As a result of our growth strategies, we believe that our liquidity and capital resources requirements will grow in absolute dollars but will be generally consistent with historical periods on an annual basis as a percentage of net revenues. We anticipate leasing additional office space, production facilities and hosting facilities in future periods as the need arises, consistent with our historical business model.

The following are contractual obligations at December 31, 2009, associated with lease obligations and other arrangements:

	Total	Less Than 1 Year	1-3 Years	3-5 Years	More Than 5 Years
			(In thousands)		
Contractual Obligations					
Capital lease obligations	$ 16	$ 10	$ 6	$ —	$—
Operating lease obligations	15,382	3,676	7,114	4,294	298
Purchase obligations	16,878	5,076	10,482	1,320	—
Total contractual obligations	$32,276	$8,762	$17,602	$5,614	$298

The table above excludes the impact of approximately $2.2 million related to unrecognized tax benefits as of December 31, 2009. The Company cannot make reliable estimates of the future cash flows by period related to this obligation.

Other than the obligations, liabilities and commitments described above, we have no significant unconditional purchase obligations or similar instruments. We are not a guarantor of any other entities' debt or other financial 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 for other contractually narrow or limited purposes. In addition, we do not have any undisclosed borrowings or debt, and we have not entered into any synthetic leases. We are, therefore, not materially exposed to any financing, liquidity, market or credit risk that could arise if we had engaged in such relationships.

Recent Accounting Pronouncements

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

Effective January 1, 2009, we adopted a new accounting standard update regarding business combinations. As codified under ASC 805 (formerly SFAS No. 141 revised 2007, *Business Combinations*), this update requires an entity to recognize the assets acquired, liabilities assumed, contractual contingencies, and contingent consideration at their fair value on the acquisition date. It further requires that acquisition-related costs be recognized separately from the acquisition and expensed as incurred; that restructuring costs generally be expensed in periods subsequent to the acquisition date; and that changes in accounting for deferred tax asset valuation allowances and acquired income tax uncertainties after the measurement period be recognized as a component of provision for taxes. In addition, acquired in-process research and development is capitalized as an intangible asset and amortized over its estimated useful life. With the adoption of this accounting standard update, any tax related adjustments associated with acquisitions that closed prior to January 1, 2009 will be recorded through income tax expense, whereas the previous accounting treatment would require any adjustment to be recognized through the purchase price. This accounting standard update applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. The adoption of these accounting updates did not have any impact on our consolidated financial statements.

Effective January 1, 2009, we adopted an accounting standard which establishes accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary, as codified in ASC 810-10-60 (formerly SFAS No. 160, *Accounting and Reporting on Non-controlling Interest in Consolidated Financial Statements, an Amendment of ARB 51*). This accounting standard states that accounting and reporting for minority interests are to be recharacterized as noncontrolling interests and classified as a component of equity. The calculation of earnings per share continues to be based on income amounts attributable to the parent. The adoption of these accounting updates did not have any impact on our consolidated financial statements.

Effective January 1, 2009, we adopted an accounting standard update regarding the determination of the useful life of intangible assets. As codified in ASC 350-30-50 (formerly FSP No. 142-3, *Determination of the Useful Life of Intangible Assets*), this update amends the factors considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under intangibles accounting. It also requires a consistent approach between the useful life of a recognized intangible asset under prior business combination accounting and the period of expected cash flows used to measure the fair value of an asset under the new business combinations accounting (as currently codified under ASC 850). The update also requires enhanced disclosures when an intangible asset's expected future cash flows are affected by an entity's intent and/or ability to renew or extend the arrangement. The adoption of these accounting updates did not have any impact on our consolidated financial statements.

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

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

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

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

ITEM 7A. *QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.*

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

At December 31, 2009, we held approximately $47.9 million par value of variable rate bond investments with a fair value of approximately $41.7 million, classified as short-term investments, with an auction reset feature ("auction rate securities" or "ARS") whose underlying assets are student loans which are substantially backed by the federal government. Since February 2008, these auctions have failed. Therefore the ARS continue to be illiquid and we will not be able to access these funds until a future auction of these investments is successful or a buyer is found outside of the auction process.

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

Although these investments continue to be illiquid, during 2009 we liquidated $4.3 million (at par value) ARS investments that were called by the state issuers.

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

ITEM 8. ***FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA.***

SHUTTERFLY, INC.
INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

Report of Independent Registered Public Accounting Firm

To Board of Directors and Shareholders of
Shutterfly, Inc.

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of income, stockholders' equity, comprehensive income, and cash flows present fairly, in all material respects, the financial position of Shutterfly, Inc. and its subsidiaries at December 31, 2009 and December 31, 2008, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2009 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule listed in the accompanying index presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2009, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for these financial statements and financial statement schedule, for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in Management's Report on Internal Control over Financial Reporting appearing under Item 9A. Our responsibility is to express opinions on these financial statements, on the financial statement schedule, and on the Company's internal control over financial reporting based on our integrated audits. We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

The Company adopted new fair value measurement and disclosure accounting principles during the year ended December 31, 2008.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ PricewaterhouseCoopers LLP

San Jose, California
February 8, 2010

SHUTTERFLY, INC.
CONSOLIDATED BALANCE SHEETS
(In thousands, except per share amounts)

	December 31, 2009	December 31, 2008
ASSETS		
Current assets:		
Cash and cash equivalents	$132,812	$ 88,164
Short-term investments	47,925	—
Accounts receivable, net	5,472	5,992
Inventories	2,968	3,610
Deferred tax asset, current portion	2,243	1,194
Prepaid expenses and other current assets	4,501	4,749
Total current assets	195,921	103,709
Long-term investments	—	52,250
Property and equipment, net	41,845	48,108
Goodwill and intangible assets, net	13,406	14,547
Deferred tax asset, net of current portion	14,674	12,266
Other assets	5,467	2,417
Total assets	$271,313	$233,297
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 13,116	$ 11,214
Accrued liabilities	32,793	24,802
Deferred revenue	8,602	9,461
Total current liabilities	54,511	45,477
Other liabilities	1,638	1,018
Total liabilities	56,149	46,495
Commitments and contingencies (Note 7)		
Stockholders' equity:		
Common stock, $0.0001 par value; 100,000 shares authorized; 25,909 and 25,138 shares issued and outstanding at December 31, 2009 and December 31, 2008, respectively	3	2
Additional paid-in capital	226,410	203,902
Accumulated deficit	(11,249)	(17,102)
Total stockholders' equity	215,164	186,802
Total liabilities and stockholders' equity	$271,313	$233,297

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

SHUTTERFLY, INC.
CONSOLIDATED STATEMENTS OF INCOME
(In thousands, except per share amounts)

	Year Ended December 31,		
	2009	**2008**	**2007**
Net revenues	$246,432	$213,480	$186,727
Cost of net revenues	111,648	96,214	84,111
Gross profit	134,784	117,266	102,616
Operating expenses:			
Technology and development	46,003	39,707	28,822
Sales and marketing	44,870	42,212	33,530
General and administrative	35,201	32,741	29,888
	126,074	114,660	92,240
Income from operations	8,710	2,606	10,376
Interest expense	(157)	(273)	(179)
Interest and other income, net	814	2,898	5,515
Income before income taxes	9,367	5,231	15,712
Provision for income taxes	(3,514)	(1,571)	(6,134)
Net income	$ 5,853	$ 3,660	$ 9,578
Net income per share:			
Basic	$ 0.23	$ 0.15	$ 0.39
Diluted	$ 0.22	$ 0.14	$ 0.36
Weighted average shares:			
Basic	25,420	25,036	24,295
Diluted	26,810	25,787	26,273

Stock-based compensation is allocated as follows (Notes 2 and 8):			
Cost of net revenues	$ 416	$ 372	$ 189
Technology and development	3,340	2,404	1,067
Sales and marketing	3,577	2,452	1,044
General and administrative	6,940	4,522	2,386

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

SHUTTERFLY, INC.
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
(In thousands)

	Year Ended December 31, 2009	2008	2007
Common stock (par value)			
Balance, beginning of year	$ 2	$ 2	$ 2
Issuance of common stock upon exercise of options and vesting of restricted stock units	1	—	—
Balance, end of year	3	2	2
Additional paid-In capital			
Balance, beginning of year	203,902	191,534	181,890
Issuance of common stock upon exercise of options, net of repurchases	1,699	899	4,983
Cancellation of common stock options and restricted shares	—	—	(162)
Stock based compensation, net of estimated forfeiture	15,844	11,313	4,796
Tax benefit of stock options	4,965	156	27
Balance, end of year	226,410	203,902	191,534
Deferred stock-based compensation			
Balance, beginning of year	—	(28)	(191)
Cancellation of common stock options and restricted shares	—	—	162
Amortization of deferred stock-based compensation, net of cancellations	—	28	1
Balance, end of year	—	—	(28)
Accumulated deficit			
Balance, beginning of year	(17,102)	(20,762)	(30,340)
Net income	5,853	3,660	9,578
Balance, end of year	(11,249)	(17,102)	(20,762)
Accumulated other comprehensive loss			
Balance, beginning of year	—	(12)	(35)
Change in unrealized loss in investments, net of tax	—	12	23
Balance, end of year	—	—	(12)
Total stockholders' equity	$215,164	$186,802	$170,734
Number of shares			
Common stock			
Balance, beginning of year	25,138	24,805	23,705
Issuance of common stock upon exercise of options and vesting of restricted stock units	771	333	1,073
Issuance of common stock upon net exercise of warrants	—	—	27
Balance, end of year	25,909	25,138	24,805

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

SHUTTERFLY, INC.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(In thousands)

	Year Ended December 31,		
	2009	**2008**	**2007**
Net Income	$5,853	$ 3,660	$9,578
Unrealized gain on investments, net of tax			
Unrealized gain (loss) arising during period	—	(5,846)	23
Less: reclassification adjustment for gain realized in net income	—	5,858	—
Total comprehensive income	$5,853	$ 3,672	$9,601

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

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

	Year Ended December 31,		
	2009	2008	2007
Cash flows from operating activities:			
Net income	$ 5,853	$ 3,660	$ 9,578
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	25,122	24,211	17,384
Amortization of intangible assets	2,072	1,827	412
Stock-based compensation, net of forfeitures	14,273	9,750	4,686
Loss on disposal of property and equipment	346	308	262
Deferred income taxes	(2,903)	(312)	5,685
Tax benefit from stock-based compensation	4,965	156	—
Excess tax benefits from stock-based compensation	(3,273)	(538)	—
Loss/(gain) on auction rate securities Rights	2,747	(9,013)	—
Loss/(gain) on auction rate securities	(2,747)	9,013	—
Changes in operating assets and liabilities:			
Accounts receivable, net	520	(1,512)	(2,316)
Inventories, net	642	1,178	(2,290)
Prepaid expenses and other current assets	501	(120)	(1,750)
Other assets	(3,282)	(243)	(1,668)
Accounts payable	1,947	2,431	(602)
Accrued and other liabilities	7,966	5,482	10,390
Deferred revenue	(859)	762	2,421
Net cash provided by operating activities	53,890	47,040	42,192
Cash flows from investing activities:			
Purchases of property and equipment	(13,762)	(18,220)	(31,881)
Capitalization of software and website development costs	(3,891)	(4,527)	(3,112)
Acquisition of business and intangibles, net of cash acquired	(795)	(10,097)	(2,858)
Purchases of short term investments	—	—	(3,000)
Proceeds from sale of short term investments	—	3,002	—
Proceeds from sale of equipment	—	6	28
Purchase of auction rate securities	—	(52,250)	—
Proceeds from the sale of auction rate securities	4,325	—	—
Net cash used in investing activities	(14,123)	(82,086)	(40,823)
Cash flows from financing activities:			
Principal payments of capital lease obligations	(91)	(808)	(2,840)
Proceeds from issuance of common stock upon exercise of stock options	2,740	1,158	4,975
Shares withheld for payment of employee's withholding tax liability	(1,041)	(260)	—
Excess tax benefits from stock-based compensation	3,273	538	27
Net cash provided by financing activities	4,881	628	2,162
Net increase/(decrease) in cash and cash equivalents	44,648	(34,418)	3,531
Cash and cash equivalents, beginning of period	88,164	122,582	119,051
Cash and cash equivalents, end of period	$132,812	$ 88,164	$122,582
Supplemental disclosures of cash flow information:			
Cash paid during the period for:			
Interest	$ 12	$ 47	$ 198
Income taxes	2,644	535	812
Supplemental schedule of non-cash investing activities			
Accrued acquisition liabilities	—	400	—
Net change in accrued purchases of property and equipment	2	—	—
Escrow liability from acquisition of business	150	—	—

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

SHUTTERFLY, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1—Description of Business

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

Note 2—Summary of Significant Accounting Policies

Principles of Consolidation

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

Use of Estimates

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

Subsequent Events Evaluation

Management has reviewed and evaluated material subsequent events from the balance sheet date of December 31, 2009 through the financial statements issue date of February 8, 2010. All appropriate subsequent event disclosures have been made in the notes to the Company's consolidated financial statements.

Cash and Cash Equivalents

The Company considers all highly liquid investments purchased with original maturities (at the date of purchase) of three months or less to be cash equivalents. Management determines the appropriate classification of cash equivalents at the time of purchase and reevaluates such designations at each balance sheet date. Cash equivalents consist principally of money market funds and commercial paper.

Investments

The Company evaluates declines in fair value of marketable securities in accordance with Accounting Standards Codification ("ASC") 320-10 (formerly Statement Financial Accounting Standard Board ("SFAS") No. 115, *Accounting for Certain Investments in Debt and Equity Securities*), and related authoritative guidance issued by the FASB in order to determine the classification of the decline in fair value as "temporary" or "other-than-temporary." A temporary decline in fair value results in an unrealized loss being recorded in the other comprehensive income (loss) component of stockholders equity. Such an unrealized loss does not affect net income (loss) for the applicable accounting period. An other-than–temporary decline in fair value is recorded as a realized loss in the consolidated statement of operations and reduces net income (loss) for the applicable accounting period. The differentiating factors between these classifications include the length of time and extent to which the market value has been less than cost, the financial condition of the issuer, and the ability and intent of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in market value.

The Company classifies its auction rate securities as trading securities, currently recorded as short term investments at December 31, 2009. Investments that the Company designates as trading assets are reported at fair value, with gains or losses resulting from changes in fair value recognized in earnings.

Fair Value

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

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

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

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

The Company utilized a discounted cash flow approach to determine the Level 3 valuation for its auction rate securities. The assumptions used in preparing the discounted cash flow model include estimates for interest rates, timing and amount of cash flows, credit and liquidity premiums, and expected holding periods of the ARS. These assumptions are volatile and subject to change as the underlying sources of these assumptions and market conditions change. They represent the Company's estimates given available data as of December 31, 2009. The Company also measures the Rights at fair value, in order to match the changes in the fair value of the auction rate securities.

Concentration of Credit Risk

Financial instruments that potentially subject the Company to credit risk consist principally of cash, cash equivalents, short term investments, and accounts receivable. As of December 31, 2009, the Company's cash and cash equivalents were maintained by financial institutions in the United States and its deposits may be in excess of insured limits. The Company believes that the financial institutions that hold its investments are financially sound and, accordingly, minimal credit risk exists with respect to these investments.

The Company's accounts receivable are derived primarily from sales to customers located in the United States who make payments through credit cards, sales of the Company's products in retail stores, sales of commercial print sources, and revenue generated from online advertisements posted on the Company's website. Credit card receivables settle relatively quickly and the Company maintains allowances for potential credit losses based on historical experience. To date, such losses have not been material and have been within management's expectations. Excluding amounts due from credit cards, as of December 31, 2009, two customers accounted for 38% and 14% of the Company's net accounts receivable. And as of December 31, 2008, the same two customers accounted for 38% and 13% of the Company's net accounts receivable.

Inventories

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

Property and Equipment

Property and equipment, including equipment under capital leases, are stated at historical cost, less accumulated depreciation and amortization. Depreciation and amortization are computed using the straight-line method over the estimated lives of the assets, generally three to five years. Amortization of equipment acquired under capital lease obligations is computed using the straight-line method over the shorter of the remaining lease term or the estimated useful life of the related assets, generally three to four years. Leasehold improvements are amortized over their estimated useful lives, or the lease term if shorter, generally three to seven years. Upon retirement or sale, the cost and related accumulated depreciation are removed from the balance sheet and the resulting gain or loss is reflected in operating expenses. Major additions and improvements are capitalized, while replacements, maintenance and repairs that do not extend the life of the asset are charged to expense as incurred.

Software and Website Development Costs

The Company capitalizes eligible costs associated with software developed or obtained for internal use in accordance with ASC 350 (formerly Statement of Position 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*, and *Emerging Issues Task Force* 00-02, *Accounting for Web Site Development Costs*). Accordingly, the Company expenses all costs that relate to the planning and post implementation phases. Payroll and payroll related costs and stock based compensation incurred in the development phase are capitalized and amortized over the product's estimated useful life, generally three years. Costs associated with minor enhancements and maintenance for the Company's website are expensed as incurred.

Long-Lived Assets

The Company reviews long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable in accordance with ASC 360-10 (formerly Statement of Financial Accounting Standards No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*). Recoverability is measured by comparison of the carrying amount to the future net cash flows which the assets are expected to generate. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the projected discounted future cash flows arising from the asset using a discount rate determined by management to be commensurate with the risk inherent to the Company's current business model.

Goodwill and Intangible Assets

The Company accounts for intangible assets and goodwill in accordance with ASC 350 (formerly SFAS No. 142, *Goodwill and Other Intangible Assets*). Goodwill and intangible assets with indefinite lives are not amortized but are tested for impairment on an annual basis during the Company's fourth quarter or whenever events or changes in circumstances indicate that the carrying amount of these assets may not be recoverable. Intangible assets with finite useful lives are amortized using the straight-line method over their useful lives and are reviewed for impairment in accordance with ASC 360, (formerly SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*).

Intangible assets are amortized on a straight-line basis over the estimated useful lives which range from one to sixteen years.

For goodwill analysis, the Company operates under one reporting unit. The Company determined the fair value of its reporting unit based on its enterprise value. This reporting unit was not at risk of failing step one of the annual goodwill impairment test for years ended December 31, 2009 and 2008.

Revenue Recognition

The Company generally recognizes revenue from product sales, net of applicable sales tax upon shipment when persuasive evidence of an arrangement exists, 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 or until the prepaid period expires. Shipping charged to customers is recognized as revenue at the time of shipment. The Company recognizes commercial print revenue upon shipment, consistent with its product revenue policy.

The Company provides its customers with a 100% satisfaction guarantee whereby products can be returned within a 30-day period for a reprint or refund. The Company maintains an allowance for estimated future returns based on historical data. The provision for estimated returns is included in accrued expenses.

The Company periodically provides incentive offers to its 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 presented in net revenues. Production costs related to free products are included in cost of revenues upon redemption.

The Company's advertising revenues are derived from the sale of online advertisements on its website. Advertising revenues are recognized as "impressions" (i.e., the number of times that an advertisement appears in pages viewed by users of the Company's website) are delivered; as "clicks" (which are generated each time users of the Company's website click through the advertisements to an advertiser's designated website) are provided to advertisers; or ratably over the term of the agreement with the expectation that the advertisement will be delivered ratably over the contract period.

Restructuring Costs

In accordance with ASC 420-10 (formerly SFAS No. 146, Accounting *for Costs Associated with Exit or Disposal Activities*), restructuring costs are recorded as incurred. The Company accrues for lease termination costs at the time a restructuring event takes place. The Company accrues for severance once the total severance pool has been calculated, approved and communicated, and recognizes the expense ratably over the required service period, from the communication date to the exit date. The Company also accelerates depreciation using a revised economic life of the leasehold improvement assets.

Advertising Costs

Advertising costs are expensed as incurred, except for direct mail advertising which is expensed when the advertising first takes place. The Company did not have any capitalized direct mail costs at December 31, 2009 and December 31, 2008. Total advertising costs are included in selling and marketing expenses and totaled approximately $14,576,000, $14,740,000 and $10,800,000 during the years ended December 31, 2009, 2008 and 2007, respectively.

Stock-Based Compensation

The Company accounts for its stock-based employee compensation plans under the fair value provisions of ASC 718 (formerly SFAS No. 123R, *Share-Based Payment*). Stock-based compensation cost is measured at the grant date, based on the fair value of the award, and is recognized as expense over the requisite service period. Cash flows resulting from the tax benefits due to tax deductions in excess of the compensation cost recognized for those options (excess tax benefits) are classified as financing cash flows.

The Company accounts for equity instruments issued to non-employees in accordance with the provisions of ASC 718 and ASC 505 (formerly Emerging Issues Task Force Abstract No. 96-18, *Accounting for Equity Instruments that are Issued to Other than Employees for Acquiring, or in Conjunction with Selling, Goods or Services*).

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

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 ASC 740 (formerly Financial Accounting Standards Board Interpretation No. 48 *Accounting for Uncertainty in Income Taxes*). The application of income tax law is inherently complex. Laws and regulations in this area are voluminous and are often ambiguous. The Company is required to make subjective assumptions and judgments regarding its income tax exposures. Interpretations and guidance surrounding income tax laws and regulations change over time. As such, changes in the Company's subjective assumptions and judgments can materially affect amounts recognized in the consolidated balance sheets and statements of operations.

The Company's policy is to recognize interest and /or penalties related to all tax positions in income tax expense. To the extent that accrued interest and penalties do not ultimately become payable, amounts accrued will be reduced and reflected as a reduction of the overall income tax provision in the period that such determination is made. No interest and penalties were accrued as of the date of adoption of ASC 740 or at December 31, 2009.

The Company is subject to taxation in the United States, California and fourteen other jurisdictions in the United States.

Net Income Per Share

Basic net income per share attributed to common shares is computed by dividing the net income 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 income per share attributed to common shares is computed by dividing the net income 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 units, common stock subject to repurchase rights, and incremental shares of common stock issuable upon the exercise of stock options.

	Year Ended December 31,		
	2009	2008	2007
	In thousands, except per share amounts		
Net income per share:			
Numerator			
Net income	$ 5,853	$ 3,660	$ 9,578
Denominator			
Weighted-average common shares outstanding	25,420	25,038	24,309
Less: Weighted-average unvested common shares subject to repurchase	—	(2)	(14)
Denominator for basic net income per share	25,420	25,036	24,295
Dilutive effect of stock options, restricted awards and shares subject to repurchase	1,390	751	1,978
Denominator for diluted net income per share	26,810	25,787	26,273
Net income per share			
Net income per share—basic	$ 0.23	$ 0.15	$ 0.39
Net income per share—diluted	$ 0.22	$ 0.14	$ 0.36

The following weighted-average outstanding options were excluded from the computation of diluted net income per common share for the periods presented because including them would have had an anti-dilutive effect (in thousands):

	Year Ended December 31,		
	2009	2008	2007
Options to purchase common stock	2,559	4,230	385

Comprehensive Income

ASC 220 (formerly SFAS No. 130, *Reporting Comprehensive Income*), establishes standards for reporting and displaying comprehensive income and comprehensive loss and its components in the consolidated financial statements. Comprehensive income is defined as the change in equity of a business enterprise during a period from transactions and other events and circumstances from non-owner sources. Comprehensive income is composed of net income and unrealized gains and losses on marketable securities, which are disclosed in the accompanying consolidated statements of comprehensive income. Unrealized gain (loss) on investments for the years ended December 31, 2009, 2008 and 2007 are net of tax benefit of $0, $3,148,000 and $13,000 respectively.

Segment Reporting

The Company operates in one industry segment — digital photofinishing services. The Company operates in one geographic area, the United States of America.

ASC 280 (formerly SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*), establishes standards for reporting information about operating segments. Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker, or decision making group, in deciding how to allocate resources and in assessing performance. The Company's chief operating decision maker is its Chief Executive Officer. The Company's Chief Executive Officer reviews financial information presented on a consolidated basis for purposes of allocating resources and evaluating financial performance. The Company has one business activity and there are no segment managers who are held accountable for operations, operating results or components below the consolidated unit level. Accordingly, the Company reports as a single operating segment.

Recent Accounting Pronouncements

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

Effective January 1, 2009, the Company adopted a new accounting standard update regarding business combinations. As codified under ASC 805 (formerly SFAS No. 141 revised 2007, *Business Combinations*), this update requires an entity to recognize the assets acquired, liabilities assumed, contractual contingencies, and contingent consideration at their fair value on the acquisition date. It further requires that acquisition-related costs be recognized separately from the acquisition and expensed as incurred; that restructuring costs generally be expensed in periods subsequent to the acquisition date; and that changes in accounting for deferred tax asset valuation allowances and acquired income tax uncertainties after the measurement period be recognized as a component of provision for taxes. In addition, acquired in-process research and development is capitalized as an intangible asset and amortized over its estimated useful life. With the adoption of this accounting standard update, any tax related adjustments associated with acquisitions that closed prior to January 1, 2009 will be recorded through income tax expense, whereas the previous accounting treatment would require any adjustment to be recognized through the purchase price. This accounting standard update applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. The adoption of these accounting updates did not have any impact on the Company's consolidated financial statements.

Effective January 1, 2009, the Company adopted an accounting standard which establishes accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary, as codified in ASC 810-10-60 (formerly SFAS No. 160, *Accounting and Reporting on Non-controlling Interest in Consolidated Financial Statements, an Amendment of ARB 51*). This accounting standard states that accounting and reporting for minority interests are to be recharacterized as noncontrolling interests and classified as a component of equity. The calculation of earnings per share continues to be based on income amounts attributable to the parent. The adoption of these accounting updates did not have any impact on the Company's consolidated financial statements.

Effective January 1, 2009, the Company adopted an accounting standard update regarding the determination of the useful life of intangible assets. As codified in ASC 350-30-50 (formerly FSP No. 142-3, *Determination of the Useful Life of Intangible Assets*), this update amends the factors considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under intangibles accounting. It also requires a consistent approach between the useful life of a recognized intangible asset under prior business combination accounting and the period of expected cash flows used to measure the fair value of an asset under the new business combinations accounting (as currently codified under ASC 850). The update also requires enhanced disclosures when an intangible asset's expected future cash flows are affected by an entity's intent and/or ability to renew or extend the arrangement. The adoption of these accounting updates did not have any impact on the Company's consolidated financial statements.

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

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

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

Effective July 1, 2009, the Company adopted The "FASB Accounting Standards Codification" and the Hierarchy of Generally Accepted Accounting Principles (ASC 105), (formerly SFAS No. 168, *The "FASB*

Accounting Standards Codification" and the Hierarchy of Generally Accepted Accounting Principles). This standard establishes only two levels of U.S. generally accepted accounting principles ("GAAP"), authoritative and nonauthoritative. The Financial Accounting Standard Board ("FASB") Accounting Standards Codification (the "Codification") became the source of authoritative, nongovernmental GAAP, except for rules and interpretive releases of the SEC, which are sources of authoritative GAAP for SEC registrants. All other non-grandfathered, non-SEC accounting literature not included in the Codification became nonauthoritative. The Company began using the new guidelines and numbering system prescribed by the Codification when referring to GAAP in the third quarter of fiscal 2009. As the Codification was not intended to change or alter existing GAAP, it did not have any impact on the Company's consolidated financial statements.

Note 3—Fair Value Measurement

The components of the Company's cash equivalents and investments, including the unrealized gains (losses) associated with each are as follows (in thousands):

	December 31, 2009			December 31, 2008		
	Cost	Unrealized Gains / (Losses) included in earnings	Fair Value	Cost	Unrealized Gains / (Losses) included in earnings	Fair Value
Cash Equivalents						
Money Market Funds	$113,966	$ —	$113,966	$ 80,410	$ —	$ 80,410
Total Cash Equivalents	113,966	—	113,966	80,410	—	80,410
Auction Rate Securities	47,925	(6,266)	41,659	52,250	(9,013)	43,237
Rights from UBS	—	6,266	6,266	—	9,013	9,013
Total Cash Equivalents and Investments	$161,891	$ —	$161,891	$132,660	$ —	$132,660

The following table represents the Company's fair value hierarchy for its financial assets (cash equivalents and short term investments) as of December 31, 2009 (in thousands):

	December 31, 2009			
	Fair Value	Level 1	Level 2	Level 3
Cash equivalents:				
Money market funds	$113,966	$113,966	$—	$ —
Short-term investments:				
Auction rate securities	41,659	—	—	41,659
Rights from UBS	6,266	—	—	6,266
Total financial assets	$161,891	$113,966	$—	$47,925

Level 3 assets consist of auction rate securities ("ARS") with an auction reset feature whose underlying assets are student loans that are substantially backed by the federal government. Because the auctions for these securities have continued to fail since February 2008, these investments are not currently trading and therefore do not have a readily determinable market value. Accordingly, the estimated fair value of the ARS no longer approximates par value. The Company's ARS investments are held by UBS AG ("UBS"), one of the Company's investment providers. In November 2008, the Company accepted an offer (the "Right") from UBS entitling the Company to sell at par value ARS purchased from UBS (approximately $47.9 million, par value at December 31,

2009) at anytime during a two-year period from June 30, 2010 through July 2, 2012. Although the Company expects to sell its ARS under the Right, if the Right is not exercised before July 2, 2012, it will expire and UBS will have no further rights or obligation to buy the Company's ARS. UBS's obligations under the Right are not secured by its assets and do not require UBS to obtain any financing to support its performance obligations under the Right. UBS has disclaimed any assurance that it will have sufficient financial resources to satisfy its obligations under the Right. The Company has valued the ARS and Right using a discounted cash flow model based on Level 3 assumptions. The assumptions used in valuing the ARS and the Right include estimates of, based on data available as of December 31, 2009, interest rates, timing and amount of cash flows, credit and liquidity premiums, expected holding periods of the ARS and bearer risk associated with UBS's financial ability to repurchase the ARS beginning June 30, 2010.

During the year ended December 31, 2009 the Company liquidated $4.3 million (at par value) ARS investments that were called by various issuers. The Company intends to exercise the UBS Right on June 30, 2010, and as a result, these ARS investments and the Right are classified as short-term investments as of December 31, 2009.

The following table provides a summary of changes in fair value of the Company's ARS investments and the Right which are both Level 3 assets as of December 31, 2009 (in thousands):

	Rights	ARS
Balance at December 31, 2008	$ 9,013	$43,237
Sales of ARS investments	—	(4,325)
Unrealized gain/(loss) included in earnings	(2,747)	2,747
Balance at December 31, 2009	$ 6,266	$41,659

Note 4—Balance Sheet Components

Intellectual Property Prepaid Royalties

In 2009, the Company entered into patent license agreements with various third parties. The Company has accounted for these agreements as prepaid royalties that are amortized over the remaining life of the patents. Amortization expense is recorded as a component of cost of revenue. The current portion of the prepaid royalty is recorded as a component of prepaid expenses and the long term portion is recorded in other assets as of December 31, 2009. Total amortization for these license agreements in 2009 was $234,000.

As of December 31, 2009, the Company had a balance of $5.1 million in unamortized prepaid royalties. Amortization of these licenses is estimated as follows (in thousands):

Year Ending:	
2010	$ 694
2011	694
2012	694
2013	694
2014	694
Thereafter	1,583
	$5,053

Property and Equipment

	December 31,	
	2009	2008
	In thousands	
Computer and other equipment	$ 84,754	$ 78,299
Software	7,122	7,450
Leasehold improvements	6,848	8,933
Furniture and fixtures	2,956	2,609
Capitalized software and website development costs	17,494	12,622
	119,174	109,913
Less: Accumulated depreciation and amortization	(77,329)	(61,805)
Net property and equipment	$ 41,845	$ 48,108

Property and equipment includes $1,212,000 and $3,356,000 of equipment and software under capital leases at December 31, 2009 and 2008, respectively. Accumulated depreciation of assets under capital leases totaled $1,199,000 and $3,010,000 at December 31, 2009 and 2008, respectively.

Depreciation and amortization expense for the years ended December 31, 2009, 2008 and 2007 was $25,122,000, $24,211,000 and $17,384,000, respectively.

Total capitalized software and website development costs, net of accumulated amortization totaled $8,629,000 and $7,133,000 at December 31, 2009 and 2008, respectively. These amounts included $1,571,000 and $1,590,000 of stock based compensation expense at December 31, 2009 and 2008 respectively. Amortization of capitalized costs totaled approximately $3,314,000, $2,456,000 and $1,467,000 for the years ended December 31, 2009, 2008 and 2007, respectively.

During the year ended December 31, 2009, the Company retired $8,910,000 of fully depreciated property and equipment, primarily building leasehold improvements and equipment associated with the closure of the Company's Hayward production facility.

During 2009, the Company recorded a loss of $266,000 associated with the impairment of certain computer equipment.

Intangible Assets

Intangible assets are composed of the following at December 31:

	Weighted Average Useful Life	December 31, 2009	December 31, 2008
		In thousands	
Purchased technology	8 Years	$ 8,578	$ 8,450
Less: accumulated amortization		(3,734)	(2,318)
		4,844	6,132
Customer relationships	3 Years	1,015	990
Less: accumulated amortization		(777)	(440)
		238	550
Licenses and other	3 Years	256	256
Less: accumulated amortization		(200)	(115)
		56	141
Total		$ 5,138	$ 6,823

Purchased technology is amortized over a period ranging from three to sixteen years. Customer relationships are amortized over a period ranging from one to three years. Licenses and other is amortized over a period ranging from two to five years.

Intangible asset amortization expense for the years ended December 31, 2009, 2008 and 2007 was $1,838,000, $1,827,000 and $412,000, respectively. Amortization of existing intangible assets is estimated to be as follows (in thousands):

Year Ending:	
2010	$1,746
2011	1,457
2012	1,312
2013	128
2014	128
Thereafter	367
	$5,138

Goodwill

Changes in the carrying amount of goodwill are as follows (in thousands):

Balance, December 31, 2007	$ 379
Acquisition of business	6,945
Goodwill adjustments	400
Balance, December 31, 2008	7,724
Acquisition of business	544
Goodwill adjustments	—
Balance, December 31, 2009	$8,268

Accrued Liabilities

	December 31, 2009	December 31, 2008
	In thousands	
Accrued marketing expenses	$10,548	$ 6,697
Accrued production costs	7,241	2,677
Accrued income and sales taxes	5,517	5,923
Accrued compensation	5,227	4,110
Accrued purchases	1,228	952
Accrued consultant expenses	1,112	1,439
Accrued other	1,920	3,004
	$32,793	$24,802

Note 5—Restructuring

In July 2008, the Company announced that effective in early 2009, it would close its Hayward production facility and begin operations at a new manufacturing facility to be located in Phoenix, Arizona. At the time of the decision, the Company recorded approximately $80,000 in contractual lease termination costs. The Company completed its closure of the Hayward facility in the first quarter of fiscal 2009. The Company paid a total of $827,000 in severance costs, which was recognized ratably over the period from the severance communication date in July 2008 through March 31, 2009. The Company recorded an additional restructuring accrual as of March 31, 2009, for rent and related costs for the remainder of the leases associated with the Hayward facility. As of December 31, 2009, the Company made all rent payments associated with the leases and no outstanding restructuring accrual exists.

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

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

Note 6—Acquisitions

TinyPictures, Inc.

On September 10, 2009, the Company acquired all of the outstanding common shares and securities convertible into common shares of TinyPictures, Inc. (“TinyPictures”) for a total aggregate purchase price of $1.3 million. The Company also granted $1.3 million in contingent consideration in the form of performance-based restricted stock units (“PBRSUs”) to continuing employees. Vesting of the PBRSUs is contingent on achieving certain performance milestones and continued employment. TinyPictures developed applications that enabled users to share images and videos to others across mobile networks and social networking platforms. The acquisition was accounted for as a non-taxable purchase transaction and, accordingly, the purchase price has been allocated to the tangible assets, liabilities assumed, and identifiable intangible assets acquired based on their estimated fair values on the acquisition date. The excess of the purchase price over the aggregate fair values was recorded as goodwill. Stock based compensation associated with the PBRSUs will be recognized when the achievement of the performance milestones are deemed probable.

The total aggregate purchase price of $1.3 million was comprised of $1.0 million in cash consideration and $0.3 million in assumed working capital deficit. Of the purchase price, $0.1 million was allocated to in-process research and development having an indefinite life and $51,000 was allocated to core technology and user base which will be amortized over their estimated useful lives of one to three years. The Company also recorded a deferred tax asset of $0.6 million which relates to the net operating loss carry-forwards from TinyPictures. The remaining excess purchase price of approximately $0.5 million was allocated to goodwill which represents the knowledge and experience of the assembled workforce and future technology. The results of operations for TinyPictures have been included in the consolidated statement of operations for the period subsequent to the acquisition date. Acquisition-related costs were included in general and administrative expenses in the Company's consolidated statement of operations for year ended December 31, 2009.

The following table presents the pro forma statements of operations obtained by combining the historical consolidated statements of operations of the Company and TinyPictures for the years ended December 31, 2009 and 2008, giving effect to the merger as if it occurred on January 1, 2009 and 2008, respectively (in thousands, except per share data):

	Year Ended December 31,	
	2009	2008
Pro forma revenue	$246,453	$213,504
Pro forma operating income/(loss)	7,083	(1,487)
Pro forma net income/(loss)	4,228	(561)
Pro forma basic and diluted net income/(loss) per share	$ 0.16	$ (0.02)

Nexo Systems, Inc .

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

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

Note 7—Commitments and Contingencies

Leases

The Company leases office and production space under various non-cancelable operating leases that expire no later than February 2016. Rent expense was $4,609,000, $2,786,000 and $1,925,000, for the years ended December 31, 2009, 2008 and 2007, respectively.

Rent expense is recorded on a straight-line basis over the lease term. When a lease provides for fixed escalations of the minimum rental payments, the difference between the straight-line rent charged to expense, and the amount payable under the lease is recognized as deferred rent.

The Company leases certain equipment under non-cancelable capital leases, that is subject to a security interest. The total outstanding obligation under capital leases at December 31, 2009 and 2008 was $15,000 and $107,000, respectively.

At December 31, 2009, the total future minimum payments under non-cancelable operating and capital leases are as follows:

	Operating Leases	Capital Leases
	In thousands	
Year Ending:		
2010	$ 3,676	$ 10
2011	2,302	6
2012	2,371	—
2013	2,441	—
2014	2,514	
Thereafter	2,078	—
Total minimum lease payments	$15,382	16
Less: amount representing interest		(1)
Present value of future minimum lease payments		15
Less: current portion		(9)
Non-current portion of capital lease obligations		$ 6

Purchase obligations consist of non-cancelable marketing agreements, co-location services and printing equipment rental that expire at various dates through the year 2013. As of December 31, 2009, the Company's purchase obligations totaled $16,878,000.

Indemnifications

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

Contingencies

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

Line of Credit

On June 29, 2009, the Company entered into a line of credit facility (the "Facility") with Silicon Valley Bank. The Facility is a $20.0 million 360-day revolving line of credit, and is collateralized by substantially all of the assets of the Company. The Company will use amounts borrowed under the Facility, if any, to finance the Company's working capital needs and for general corporate purposes, including future acquisitions. The line of credit also has debt covenants which require the maintenance of certain financial ratios. As of December 31, 2009, we were in compliance with those covenants. As of December 31, 2009, the Company has not drawn on the line of credit. The Company incurred $82,000 of Facility origination costs which have been capitalized within prepaid expenses and will be amortized over the twelve month term of the Facility.

Legal Matters

On June 25, 2009, Soverain Software LLC filed a complaint for alleged patent infringement against the Company and seventeen other defendants in *Soverain Software LLC. v J.C.Penny Corp. et.al.,* Civ. No. 6:09-CV-274, in the Eastern District of Texas, Tyler Division. The Complaint asserts infringement of U.S. Patent nos. 5,715,314 and 5,909,492, which claim network sales systems including, among other things, a buyer computer and a shopping cart computer, and U.S. Patent no. 7,272,639, which claims, among other things, a method of processing service requests from a client to a server system through a network using session identifiers. The Complaint asserts that the Company directly or indirectly infringe the patents without providing any details concerning the alleged infringement, and it seeks unspecified damages and injunctive relief. On December 30, 2009, pursuant to a patent license agreement between the parties dated December 21, 2009, and a Stipulation filed by the parties, the Court dismissed with prejudice Soverain's claims against Shutterfly and Shutterfly's counterclaims against Soverain.

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

On or about February 5, 2008, Parallel Networks, LLC filed a lawsuit in the United States District Court for the Eastern District of Texas, against the Company and several other defendants alleging patent infringement. The Parallel Networks complaint seeks unspecified damages, costs, interest and attorneys' fees, and an injunction against all parties. The Company filed an answer to the complaint on April 29, 2008. On July 14, 2008, we and other defendants filed a motion to stay the lawsuit pending the reexamination of the patents-in-suit by the United States Patent and Trademark Office. On December 23, 2008 that motion was denied. On January 12, 2009, the court entered a revised Agreed Docket Control order setting a schedule for deadlines in the case. The case against the Company was resolved by settlement and pursuant to a patent license agreement between the parties dated May 5, 2009, the Court dismissed with prejudice Parallel Networks' claims against the Company on May 18, 2009.

In addition to the above cases, from time to time, the Company may be involved in various legal proceedings arising in the ordinary course of business. In all cases, at each reporting period, the Company evaluates whether or not a potential loss amount or a potential range of loss is probable and reasonably estimable under the provisions of ASC 450 (formerly FAS 5, *Accounting for Contingencies*). In such cases, the Company accrues for the amount, or if a range, the Company accrues the low end of the range as a component of legal expense.

Note 8—Stock Based Compensation

1999 Stock Plan

In September 1999, the Company adopted the 1999 Stock Plan (the "1999 Plan"). Under the 1999 Plan, the Company issued shares of common stock and options to purchase common stock to employees, directors and consultants. Options granted under the Plan were incentive stock options or non-qualified stock options. Incentive stock options ("ISO") were granted only to Company employees, which includes officers and directors of the Company. Non-qualified stock options ("NSO") and stock purchase rights were able to be granted to employees and consultants. Options under the Plan were to be granted at prices not less than 85% of the deemed fair 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 and NSO was not less than 100% and 85% of the deemed fair value of the shares on the date of grant, respectively, and (ii) the exercise price of an ISO and NSO granted to a 10% stockholder 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 became exercisable. The term of the options was to be no longer than five years for ISOs for which the grantee owns 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 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, restricted stock units, and performance shares.

Options issued under the 2006 Plan are generally for periods not to exceed 10 years and are issued at the fair value of the shares of common stock on the date of grant as determined by the Board. Prior to the Company's IPO, the Board determined the fair value of common stock in good faith based on the best information available to the Board and Company's management at the time of the grant. Following the IPO, the fair value of the Company's common stock is determined by the last sale price of such stock on the Nasdaq Global Market. Options issued under the 2006 Plan typically vest 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. Option holders under the 2006 Plan are allowed to exercise options prior to vesting.

At the time of adoption of the 2006 Plan, there were 1,358,352 shares of common stock authorized for issuance under the 2006 Plan, plus 92,999 shares of common stock from the 1999 Plan that were unissued. The 2006 Plan provides for automatic replenishments on January 1 of 2008, 2009, and 2010, of the lesser of a) 4.62%

of common stock issued and outstanding on the December 31 immediately prior to the date of increase or b) a lesser number as determined by the Board.

Stock Option Activity

A summary of the status of the Company's stock option plans at December 31, 2009 and changes during the period are presented in the table below (share numbers and aggregate intrinsic value in thousands):

	Shares Available for Grant	Number of Options Outstanding	Weighted Average Exercise Price	Weighted Average Contractual Term (Years)	Aggregate Intrinsic Value
Balances, December 31, 2008	1,223	5,529	$13.41		
Additional authorized	1,161	—	—		
Granted	(159)	159	13.80		
Exercised	—	(450)	6.10		
Forfeited, cancelled or expired	549	(549)	15.51		
Balances, December 31, 2009	2,774	4,689	$13.88	6.6	$26,490
Options vested and expected to vest at December 31, 2009		4,413	$13.57	6.5	$25,801
Options vested at December 31, 2009		3,572	$12.42	6.1	$23,662

As of December 31, 2008 and 2007, there were 3,237,000 and 1,917,000 options vested, respectively.

During the year ended December 31, 2009, the Company granted stock options to purchase an aggregate of 159,000 shares of common stock with a weighted average grant-date fair value of $6.61 per share. In fiscal years ended December 2008 and 2007, the Company granted stock options to purchase an aggregate of 642,000 and 2,217,000 shares of common stock, respectively, with a weighted average grant-date value of $5.99 and $9.33 per share, respectively.

The total intrinsic value of options exercised during the twelve months ended December 31, 2009, 2008 and 2007 was $3,963,000, $3,662,000 and $18,136,000, respectively. Net cash proceeds from the exercise of stock options were $2,740,000 for the twelve months ended December 31, 2009.

The Company has $10.3 million of state net operating losses, associated with windfall tax benefit that will be recorded in additional paid in capital when realized. In 2009, the Company recognized all of its federal net operating losses associated with windfall tax benefits from the exercise of options.

Valuation of Stock Options

The Company estimated the fair value of each option award on the date of grant using the Black-Scholes option-pricing model and the assumptions noted in the following table. Expected volatility is based on the historical and implied volatility of a peer group of publicly traded entities. The expected term of options gave consideration to historical exercises, post vest 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 twelve months ended December 31, 2009, 2008, and 2007, were as follows:

	Year Ended December 31,		
	2009	2008	2007
Dividend yield	—	—	—
Annual risk free rate of return	2.3%	2.5%	4.1%
Expected volatility	54.1%	51.7%	45.0%
Expected term (years)	4.6	4.4	4.4

Employee stock-based compensation expense recognized during the years ended December 31, 2009 and 2008 was calculated based on awards ultimately expected to vest and has been reduced for estimated forfeitures. Forfeitures are estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

Restricted Stock Units

The Company grants restricted stock units ("RSUs") to its employees under the provisions of the 2006 Equity Incentive Plan. The cost of RSUs is determined using the fair value of the Company's common stock on the date of grant. RSUs typically vest and become exercisable annually, based on a two, three or four year total vesting term. Compensation cost is amortized on a straight-line basis over the requisite service period.

Restricted Stock Unit Activity

A summary of the Company's restricted stock unit activity for the twelve months ended December 31, 2009, is as follows (share numbers in thousands):

	Restricted Stock Units & Awards	Weighted Average Grant Date Fair Value
Balances, December 31, 2008	958	$12.11
Granted	1,513	10.58
Released	(398)	13.74
Forfeited, cancelled or expired	(182)	12.89
Balances, December 31, 2009	1,891	$10.48
Restricted stock units expected to vest, December 31, 2009	1,546	

Included in the RSU grants for the twelve months ended December 31, 2009 are 326,000 RSUs that have both performance and service vesting criteria ("PBRSU"). The performance criteria are tied to the Company's quarterly financial performance and the vesting period is three years. Compensation cost associated with these PBRSUs is recognized on an accelerated attribution model and ultimately based on whether or not satisfaction of the performance criteria is probable. As of December 31, 2009, the performance criteria for all fiscal quarters were met and the associated stock based compensation has been recognized.

In connection with the acquisition of TinyPictures, Inc. on September 10, 2009, the Company granted PBRSUs to existing TinyPictures employees. Vesting of these awards is contingent on achieving certain performance milestones and continued employment. The Company will begin recognizing stock based compensation in the period in which achievement of each milestone is deemed probable. In 2009, the Company recognized $313,000 in stock based compensation associated with this performance program.

During the years ended December 31, 2009 and 2008, the fair value of awards vested were $5,733,000 and $699,000, respectively.

Inducement Awards

During the twelve months ended December 31, 2009, the Company granted inducement awards of restricted stock units to an executive. These inducement grants were approved by the Company's Board of Directors and were not issued under a shareholder approved plan. A total of 200,000 restricted stock units were granted under this nonqualified agreement. These grants vest over a three year period beginning on the grant date.

At December 31, 2009, the Company had $21,401,000 of total unrecognized compensation expense, net of estimated forfeitures, related to stock options and stock awards that will be recognized over a weighted-average period of approximately two years.

Note 9—Income Taxes

The components of the provision for income taxes are as follows (in thousands):

	December 31,		
	2009	2008	2007
Federal:			
Current	$ 5,440	$ 727	$ 206
Deferred	(2,162)	2,640	5,013
	3,278	3,367	5,219
State:			
Current	977	1,156	216
Deferred	(741)	(2,952)	699
	236	(1,796)	915
Total income tax expense (benefit):			
Current	6,417	1,883	422
Deferred	(2,903)	(312)	5,712
	$ 3,514	$ 1,571	$6,134

The Company's actual tax expense (benefit) differed from the statutory federal income tax rate of 34.0%, as follows:

	December 31,		
	2009	2008	2007
Income tax expense at statutory rate	34.0%	34.0%	34.0%
State income taxes	3.5%	(3.7)%	4.6%
Stock-based compensation	6.2%	16.7%	2.6%
R&D tax credit	(6.3)%	(17.4)%	(1.7)%
Other	0.1%	0.4%	(0.5)%
	37.5%	30.0%	39.0%

At December 31, 2009, the Company had approximately $32.7 million of state net operating loss carryforwards to reduce future regular taxable income. These carryforwards will expire beginning in the year 2014 through 2016 for state purposes, if not utilized. The Company recognized the remaining federal net operating loss carryforward in 2009, except for federal net operating losses associated with the Company's acquisition of TinyPictures in the amount of $1.7 million. The Company will begin accruing current cash taxes payable for federal purposes in 2010.

The Tax Reform Act of 1986 limits the use of net operating loss and tax credit carryforwards in the case of an "ownership change" of a corporation or separate return loss year limitations. Any ownership changes, as defined, may restrict utilization of carryforwards.

The Company also had federal and state research and development credit carryforwards of approximately $1.8 million and $1.8 million for federal and state income tax purposes, respectively, at December 31, 2009. The research and development credits may be carried forward over a period of 20 years for federal tax purposes, indefinitely for California tax purposes, and 15 years for Arizona purposes. The research and development tax credit will expire starting in 2018 for federal and 2023 for Arizona.

The components of the net deferred tax assets as of December 31, 2009 and 2008 are as follows (in thousands):

	December 31,	
	2009	2008
Deferred tax assets:		
Net operating loss carryforwards	$ 1,837	$ 1,240
Reserves and other tax benefits	6,909	4,701
Tax credits	4,508	4,499
Depreciation and amortization	2,897	2,612
Other	766	408
Deferred tax assets	16,917	13,460
Deferred tax liabilities:		
Deferred tax liabilities	—	—
Net deferred tax assets	$16,917	$13,460

As of January 1, 2009, the Company had $1,766,000 of unrecognized tax benefits. As of December 31, 2009, the Company booked an additional $551,000 for unrecognized tax benefits for fiscal 2009. A reconciliation of the beginning and ending amounts of unrecognized income tax benefits during the twelve month periods ended December 31, 2009, 2008 and 2007 is as follows (in thousands):

	2009	2008	2007
Balance of unrecognized tax benefits at January 1	$1,766	$ 756	$1,200
Additions for tax positions of prior years	—	455	—
Additions for tax positions related to current year	551	555	259
Reductions for tax positions of prior years	(138)	—	(607)
Settlement of franchise tax audit	—	—	(96)
Balance of unrecognized tax benefits at December 31	$2,179	$1,766	$ 756

Although timing of the resolution or closure on audits is highly uncertain, the Company does not believe it is reasonably possible that the unrecognized tax benefits would materially change in the next twelve months. The amount of unrecognized tax benefits, if recognized, would affect the effective tax rate.

As of December 31, 2009, the Company is subject to taxation in the United States, California, and fourteen other jurisdictions in the United States.

Note 10—Employee Benefit Plan

In 2000, the Company established a 401(k) plan under the provisions of which eligible employees may contribute an amount up to 50% of their compensation on a pre-tax basis, subject to IRS limitations. The Company matches employees' contributions at the discretion of the Board.

In 2009 and 2008, there were no discretionary contributions.

Note 11—Quarterly Financial Data (Unaudited)

Summarized quarterly financial data for the years ended December 31, 2009 and 2008, are as follows (in thousands, except per share amounts):

	Year Ended December 31, 2009			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Net Revenues	$36,012	$38,858	$40,495	$131,067
Gross Profit	$16,340	$18,789	$19,075	$ 80,580
Net income (loss)	$ (6,232)	$ (5,655)	$ (6,346)	$ 24,086
Net income (loss) per common share:				
Basic	$ (0.25)	$ (0.22)	$ (0.25)	$ 0.93
Diluted	$ (0.25)	$ (0.22)	$ (0.25)	$ 0.88

	Year Ended December 31, 2008			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Net Revenues	$34,338	$35,447	$35,953	$107,742
Gross Profit	$16,401	$18,058	$17,502	$ 65,306
Net income (loss)	$ (3,762)	$ (4,146)	$ (2,800)	$ 14,369
Net income (loss) per common share:				
Basic	$ (0.15)	$ (0.17)	$ (0.11)	$ 0.57
Diluted	$ (0.15)	$ (0.17)	$ (0.11)	$ 0.56

Schedule II

Valuation and Qualifying Accounts

	Balance at Beginning of Period	Additions: Charged to Costs and Expenses	Additions: Charged to Other Accounts	Deductions	Balance at End of Period
			In thousands		
Allowance for Doubtful Accounts Receivable					
Year ended December 31, 2007	$—	—	—	—	—
Year ended December 31, 2008	$—	—	—	—	—
Year ended December 31, 2009	$—	23	—	—	23

ITEM 9. *CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE.*

Not applicable.

ITEM 9A. *CONTROLS AND PROCEDURES.*

Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures as of December 31, 2009. 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.

Our management, with the participation of the Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the Company's disclosure controls and procedures as of the end of the period covered by this annual report on Form 10-K. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that, as of December 31, 2009, our disclosure controls and procedures were effective at the reasonable assurance level.

Management's Report on Internal Control over Financial Reporting

Management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15 (f) and 15(d)-15(f) under the Securities Exchange Act of 1934. The Company's internal control over financial reporting is a process designed by, or under the supervision of, our Chief Executive Officer and Chief Financial Officer, and effected by our board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. Internal control over financial reporting includes those policies and procedures that:

- pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the Company;
- provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and
- provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect all misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions or that the degree of compliance with the policies or procedures may change over time.

Our management, under the supervision of our Chief Executive Officer and Chief Financial Officer, conducted an evaluation of the effectiveness of our internal control over financial reporting based on the framework in Internal Control—Integrated Framework, issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this evaluation, management concluded that our internal control over financial reporting was effective as of December 31, 2009.

The Company reviewed the results of management's assessment with the Audit Committee of the Board of Directors. The effectiveness of the Company's internal control over financial reporting as of December 31, 2009 has been audited by PricewaterhouseCoopers LLP, an independent registered public accounting firm, as stated in their report which appears herein.

Remediation of Material Weakness

In Management's Report on Internal Control over Financial Reporting included in our restated Annual Report on Form 10-K/A for the year ended December 31, 2008, and our quarterly report on Form 10-Q for the fiscal quarter ended September 30, 2009, our management concluded that, as of December 31, 2008 and September 30, 2009, our internal control over financial reporting was not effective to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external reporting purposes in accordance with GAAP due to the following material weakness:

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

Subsequent to the identification of the material weakness in October 2009, we have taken the following remediation measures related to the calculation of stock-based compensation expense, the application of the forfeiture rate, and the overall reliance on the third party software information for financial reporting purposes:

- Identified all significant reports generated from the third party equity software related to financial reporting and implemented controls over the completeness and accuracy of these reports. These controls consist of:

  (i) cross-validating report data to another source,

  (ii) manually recalculating the report data to ensure that the software is producing results compliant with generally accepted accounting principles, and

  (iii) manually calculating stock-based compensation on an individual grant basis for a sample of equity awards to verify that the report data is consistent with our expected outcome.

- Enhanced existing financial reporting controls to include additional review steps with respect to significant reports generated from the third party equity software, including review of alerts and updates from the third party equity software provider, review of report parameters and review of events that would impact accounting for equity-related accounts and disclosures.

During the quarter ended December 31, 2009, management tested the design and operating effectiveness of the newly implemented controls and concluded that the material weakness described above has been remediated as of December 31, 2009.

Changes in Internal Control Over Financial Reporting

As described above under Remediation of Material Weakness, there were changes in internal control over financial reporting that occurred during the quarter ended December 31, 2009 that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Limitation on Effectiveness of Controls

Management does not expect that our disclosure controls and procedures or our internal control over financial reporting will prevent or detect all error and fraud. Any control system, no matter how well designed and operated, is based upon certain assumptions and can provide only reasonable, not absolute, assurance that its objectives will be met. Further, no evaluation of controls can provide absolute assurance that misstatements due to error or fraud will not occur or that all control issues and instances of fraud, if any, within the Company have been detected.

ITEM 9B. *OTHER INFORMATION.*

None.

PART III

ITEM 10. *DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE.*

The information concerning our directors required by this Item is incorporated by reference to the section in our Proxy Statement entitled "Proposal No. 1—Election of Directors."

The information concerning our executive officers required by this Item is incorporated by reference to the section in our Proxy Statement entitled "Executive Officers."

The information concerning compliance with Section 16(a) of the Securities Exchange Act of 1934 required by this Item is incorporated by reference to the section in our Proxy Statement entitled "Section 16(a) Beneficial Ownership Reporting Compliance."

We have adopted a written code of ethics for financial employees that applies to our principal executive officer, principal financial officer, principal accounting officer, controller and other employees of the finance department designated by the Company's Chief Financial Officer. This code of ethics, titled the "Code of Conduct and Ethics for Chief Executive Officer and Senior Financial Department Personnel," can be found on our website at www.shutterfly.com . We intend to make all required disclosures concerning any amendments to, or waivers from, our code of ethics on our website.

The information concerning material changes to the procedures by which stockholders may recommend nominees to the Board of Directors required by this Item is incorporated by reference to information set forth in the Proxy Statement, in the section entitled "Information Regarding the Board of Directors and its Committees."

The information concerning the audit committee of the Board of Directors and the audit committee financial experts required by this Item is incorporated by reference to information set forth in the Proxy Statement, in the section entitled "Information Regarding the Board of Directors and its Committees."

The information concerning the role of compensation consultants is incorporated by reference to information set forth in the Proxy Statement.

The information concerning board leadership structure and role in risk oversight is incorporated by reference to information set forth in the Proxy Statement.

ITEM 11. *EXECUTIVE COMPENSATION.*

The information required by this Item with respect to executive compensation, risk management and the compensation committee of the Board of Directors is incorporated by reference to information set forth in the Proxy Statement.

ITEM 12. *SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS.*

The information required by this Item is incorporated by reference to information set forth in the Proxy Statement under the headings "Security Ownership of Certain Beneficial Owners and Management" and "Equity Compensation Plan Information."

ITEM 13. *CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE.*

The information required by this Item with respect to director independence is incorporated by reference to information set forth in the Proxy Statement.

The information concerning certain relationships and related transactions required by this Item is incorporated by reference to the section in our Proxy Statement entitled “Certain Transactions.”

ITEM 14. ***PRINCIPAL ACCOUNTANT FEES AND SERVICES.***

The information concerning principal accountant fees and services required by this Item is incorporated by reference to the section in our Proxy Statement entitled “Ratification of Selection of Independent Registered Public Accounting Firm.”

PART IV

ITEM 15. ***EXHIBITS AND FINANCIAL STATEMENT SCHEDULES .***

(a) The following documents are filed as part of this annual report:

1. *Financial Statements*. The consolidated financial statements of Shutterfly, Inc. are incorporated by reference to Part II, Item 8 of this annual report.

2. *Financial Statement Schedule*. The Valuation and Qualifying Accounts schedule is incorporated by reference to Part II, Item 8 of this annual report.

3. *Exhibits*. We have filed, or incorporated into this report by reference, the exhibits listed on the accompanying Index to Exhibits immediately following the signature page of this Form 10-K.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

Dated: February 8, 2010

SHUTTERFLY, INC.
(Registrant)

By: /s/ MARK J. RUBASH

Mark J. Rubash
Senior Vice President and Chief Financial Officer
(Principal Financial Officer)

POWER OF ATTORNEY

KNOW ALL PERSONS BY THESE PRESENTS, that each person whose signature appears below constitutes and appoints Jeffrey T. Housenbold and Mark J. Rubash, jointly and severally, his or her attorneys-in-fact, each with the power of substitution, for him or her in any and all capacities, to sign any amendments to this Report on Form 10-K and to file same, with exhibits thereto and other documents in connection therewith, with the Securities and Exchange Commission, hereby ratifying and confirming all that each of said attorneys-in-fact, or his substitutes, may do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and dates indicated.

Signature	Title	Date
/s/ JEFFREY T. HOUSENBOLD **Jeffrey T. Housenbold**	President, Chief Executive Officer and Director (Principal Executive Officer)	February 8, 2010
/s/ MARK J. RUBASH **Mark J. Rubash**	Senior Vice President and Chief Financial Officer (Principal Financial and Accounting Officer)	February 8, 2010
/s/ PHILIP A. MARINEAU **Philip A. Marineau**	Chairman of the Board of Directors and Director	February 8, 2010
/s/ ERIC J. KELLER **Eric J. Keller**	Director	February 8, 2010
/s/ STEPHEN J. KILLEEN **Stephen J. Killeen**	Director	February 8, 2010
/s/ NANCY J. SCHOENDORF **Nancy J. Schoendorf**	Director	February 8, 2010
/s/ BRIAN T. SWETTE **Brian T. Swette**	Director	February 8, 2010
/s/ JAMES N. WHITE **James N. White**	Director	February 8, 2010

INDEX TO EXHIBITS

Exhibit Number	Exhibit Description	Incorporated by Reference				Provided Herewith
		Form	File No.	Date of First Filing	Exhibit Number	
3.01	Registrants' Restated Certificate of Incorporation.	S-1	333-135426	June 29, 2006	3.03	
3.02	Registrant's Restated Bylaws.	S-1	333-135426	June 29, 2006	3.05	
4.01	Form of Registrant's common stock certificate.	S-1	333-135426	June 29, 2006	4.01	
4.02	Fifth Amended and Restated Investors' Rights Agreement, dated as of November 11, 2005, by and among the Registrant and certain investors of Registrant.	S-1	333-135426	June 29, 2006	4.02	
10.01	Form of Indemnity Agreement.	S-1	333-135426	June 29, 2006	10.01	
10.02	1999 Stock Plan and forms of stock option agreement and a stock option exercise agreement.*	S-1	333-135426	June 29, 2006	10.02	
10.03	2006 Equity Incentive Plan and forms of stock option agreement, stock option exercise agreement, restricted stock agreement, restricted stock unit agreement, stock appreciation right agreement and stock bonus agreement.*	S-1/A	333-135426	June 29, 2006	10.03	
10.04	Lease Agreement, as amended, dated July 5, 1999, by and between the Registrant and Westport Joint Venture, as amended to date.	S-1	333-135426	June 29, 2006	10.04	
10.05	Agreement of Lease, dated as of August 1, 2005, by and between the Registrant and DCT-CA 2004 RN Portfolio L, LP, as amended to date.	S-1	333-135426	June 29, 2006	10.05	
10.06	Lease, dated as of March 7, 2000, by and between the Registrant and 3168 Corporate Place Associates, LLC, as amended to date.	S-1	333-135426	June 29, 2006	10.06	
10.07	Lease, dated as of April 6, 2000, by and between the Registrant and 3168 Corporate Place Associates, LLC, as amended to date.	S-1	333-135426	June 29, 2006	10.07	
10.08	Offer letter dated January 5, 2005 for Jeffrey T. Housenbold.*	S-1	333-135426	June 29, 2006	10.08	
10.09	Offer letter dated March 25, 2005 for Douglas J. Galen.*	S-1	333-135426	June 29, 2006	10.12	
10.10	Supply Agreement, dated as of September 15, 2005, by and between Registrant and Fuji Photo Film U.S.A., Inc.**	S-1	333-135426	June 29, 2006	10.14	

Exhibit Number	Exhibit Description	Incorporated by Reference Form	File No.	Date of First Filing	Exhibit Number	Provided Herewith
10.11	Offer letter dated January 17, 2007 for Dwayne Black.*	10-K	001-33031	March 20, 2007	10.15	
10.12	Supply Agreement, dated as of April 20, 2007, by and between Registrant and FujiFilm U.S.A, Inc.**	10-Q	001-33031	August 1, 2007	10.18	
10.13	Offer letter dated May 17, 2007 for Kathryn E. Olson.*	10-K	001-33031	March 10, 2008	10.19	
10.14	Offer letter dated November 27, 2007 for Mark J. Rubash.*	10-K	001-33031	March 10, 2008	10.20	
10.15	Lease Agreement, as amended, dated as of December 22, 2006, by and between the Registrant and 3915 Shopton Road, LLC, as amended to date.	10-K	001-33031	March 10, 2008	10.22	
10.16	First Amendment to Lease (Expansion), dated as of April 30, 2007, by and between the Registrant and Westport Office Park, LLC, as amended to date.	10-K	001-33031	March 10, 2008	10.23	
10.17	Transition Agreement between the Registrant and Stanford Au dated August 26, 2008.*	8-K	001-33031	August 27, 2008	99.1	
10.18	Lease Agreement between Liberty Cotton Center LLC and the Registrant, dated August 22, 2008, as amended on October 29, 2008.	10-Q	001-33031	October 31, 2008	10.02	
10.19	Amendment to Offer Letter dated December 26, 2008 for Mark J. Rubash.*	10-K	001-33031	February 24, 2009	10.19	
10.20	Amendment to Offer Letter dated December 23, 2008 for Dwayne Black.*	10-K	001-33031	February 24, 2009	10.20	
10.21	Amendment to Offer Letter dated December 31, 2008 for Douglas J. Galen.*	10-K	001-33031	February 24, 2009	10.21	
10.22	Amendment to Offer Letter dated December 31, 2008 for Kathryn E. Olson.*	10-K	001-33031	February 24, 2009	10.22	
10.23	Temporary Sublease, Assignment and Assumption of Lease and Consent to Assignment, dated May 7, 2008, by and between the Registrant and MetricStream, Inc.	10-K	001-33031	February 24, 2009	10.23	
10.24	Transition Agreement between the Company and Kathryn E. Olson dated March 20, 2009.*	10-Q	001-33031	May 1, 2009	10.01	
10.25	Amendment to Employment Agreement dated December 8, 2008 for Jeffrey T. Housenbold.*	10-Q	001-33031	May 1, 2009	10.02	

Exhibit Number	Exhibit Description	Incorporated by Reference Form	File No.	Date of First Filing	Exhibit Number	Provided Herewith
10.26	Amendment Number 2 to Employment Agreement dated March 12, 2009 for Jeffrey T. Housenbold.*	10-Q	001-33031	May 1, 2009	10.03	
10.27	Offer Letter between Company and Peter Elarde, dated August 30, 2001.*	10-Q	001-33031	May 1, 2009	10.04	
10.28	Amendment to Offer Letter dated December 30, 2008 for Peter Elarde.*	10-Q	001-33031	May 1, 2009	10.05	
10.29	Offer Letter between Company and Neil Day, dated April 17, 2009.*	10-Q	001-33031	July 31, 2009	10.01	
21.01	Subsidiaries of the Registrant.					X
23.01	Consent of Independent Registered Public Accounting Firm.					X
24.01	Power of Attorney. (See page 107 of this Form 10-K)					X
31.01	Certification of Chief Executive Officer Pursuant to Securities Exchange Act Rule 13a-14(a).					X
31.02	Certification of Chief Financial Officer Pursuant to Securities Exchange Act Rule 13a-14(a).					X
32.01	Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350 and Securities Exchange Act Rule 13a-14(b).***					X
32.02	Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350 and Securities Exchange Act Rule 13a-14(b).***					X

* Represents a management contract or compensatory plan.

** Confidential treatment has been granted for certain portions of this document pursuant to an application for confidential treatment sent to the Securities and Exchange Commission. Such portions are omitted from this filing and were filed separately with the Securities and Exchange Commission.

*** 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.

Exhibit 31.01

CERTIFICATION OF CHIEF EXECUTIVE OFFICER
PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

I, Jeffrey T. Housenbold, certify that:

1. I have reviewed this annual report on Form 10-K of Shutterfly, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

d) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

By: /s/ JEFFREY T. HOUSENBOLD

Jeffrey T. Housenbold
President and Chief Executive Officer
(Principal Executive Officer)

Date: February 8, 2010

Exhibit 31.02

CERTIFICATION OF CHIEF FINANCIAL OFFICER
PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

I, Mark J. Rubash, certify that:

1. I have reviewed this annual report on Form 10-K of Shutterfly, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

d) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

By: /s/ MARK J. RUBASH

Mark J. Rubash
Senior Vice President and Chief Financial Officer
(Principal Financial Officer)

Date: February 8, 2010

Exhibit 32.01

**CERTIFICATION OF CHIEF EXECUTIVE OFFICER
PURSUANT TO
18 U.S.C. SECTION 1350**

The undersigned, Jeffrey T. Housenbold, the President and Chief Executive Officer of Shutterfly, Inc. (the "Company"), pursuant to 18 U.S.C. §1350, hereby certifies that:

(i) the Annual Report on Form 10-K for the period ended December 31, 2009 of the Company (the "Report") fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(ii) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

By: /s/ JEFFREY T. HOUSENBOLD

Jeffrey T. Housenbold
President and Chief Executive Officer
(Principal Executive Officer)

Date: February 8, 2010

Exhibit 32.02

**CERTIFICATION OF CHIEF FINANCIAL OFFICER
PURSUANT TO
18 U.S.C. SECTION 1350**

The undersigned, Mark J. Rubash, Senior Vice President and Chief Financial Officer of Shutterfly, Inc. (the "Company"), pursuant to 18 U.S.C. §1350, hereby certifies:

(i) the Annual Report on Form 10-K for the period ended December 31, 2009 of the Company (the "Report") fully complies with the requirements of Section 13(a) and 15(d) of the Securities Exchange Act of 1934; and

(ii) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

By: /s/ MARK J. RUBASH

Mark J. Rubash
Senior Vice President and Chief Financial Officer
(Principal Financial Officer)

Date: February 8, 2010

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FSC

Mixed Sources

Product group from well-managed forests, controlled sources and recycled wood or fiber

www.fsc.org Cert no. SCS-COC-000648

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CORPORATE AND STOCKHOLDER INFORMATION

Board of Directors
Philip A. Marineau
Chairman of the Board and Partner
at LNK Partners

Jeffrey T. Housenbold
President, Chief Executive Officer and Director,
Shutterfly, Inc.

Eric J. Keller
Chief Operating Officer, Kleiner Perkins
Caufield & Byers

Stephen J. Killeen
Executive Chairman, The CarbonNeutral Company

Nancy J. Schoendorf
Managing Partner, Mohr, Davidow Ventures

Brian T. Swette
Non-Executive Chairman, Burger King

James N. White
Managing Director, Sutter Hill Ventures

Executive Management Team
Jeffrey T. Housenbold
President, Chief Executive Officer and Director

Mark J. Rubash
Senior Vice President and Chief Financial Officer

Dwayne A. Black
Senior Vice President, Operations

Neil M. Day
Senior Vice President and Chief Technology Officer

Douglas J. Galen
Senior Vice President, Business and Corporate
Development

Daniel C. McCormick
Senior Vice President, Products & Services

Peter C. Elarde
Senior Vice President and Chief Marketing Officer

Peter A. Navin
Senior Vice President, Human Resources

Obtaining Financial Statements
A copy of our Annual Report on Form 10-K is posted to our website. You may also obtain a copy by written or email request to:

Investor Relations
Shutterfly, Inc.
2800 Bridge Parkway
Redwood City, California 94065
Email: ***IRinquiries@shutterfly.com***

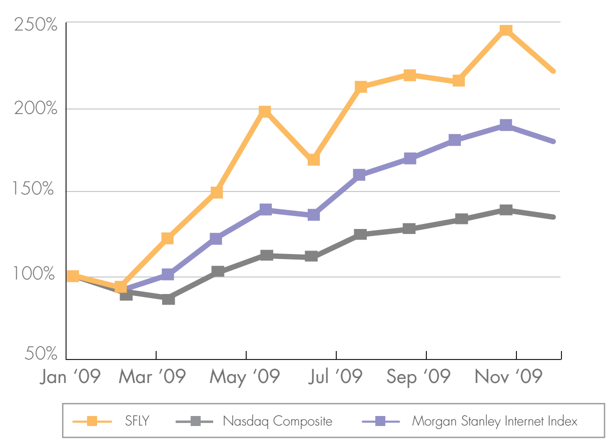
Trading Information
The common stock of Shutterfly, Inc. is traded on the Nasdaq Stock Market (symbol: SFLY). If you wish to become a stockholder, please contact a stockbroker.

Annual Meeting
May 20, 2010
11:00 a.m. (PDT)
Hotel Sofitel
223 Dolphin Drive,
Redwood City, CA 94065

Transfer Agent
Information regarding stock certificates, change of address, ownership transfer or other stock matters can be obtained from:
BNY Mellon Shareowner Services
P.O. Box 358015
Pittsburgh, PA 15252
www.bnymellon.com/shareowner/isd
877-905-1585

Independent Public Accounting Firm
PricewaterhouseCoopers LLP

Performance Graph
The following graph compares the total cumulative stockholder return on the Company's common stock with the total cumulative return of the Nasdaq Market Index and Morgan Stanley Internet Index on a monthly basis for calendar year 2009. Our stock performance shown in the graph below is not indicative of future stock price performance.



The above graph and related information shall not be deemed "soliciting material" or be deemed to be "filed" with the SEC, nor shall such information be incorporated by reference into any future filing, except to the extent that we specifically incorporate it by reference into such filing.

visit our website at **www.shutterfly.com**

shutterfly®
www.shutterfly.com

2800 Bridge Parkway
Redwood City, CA 94065