



2010 ANNUAL REPORT

Shutterfly, Inc.

LETTER TO STOCKHOLDERS

Dear Shutterfly Stockholder:

We are pleased to report our 2010 performance. Shutterfly continues to see very solid growth rates and increasing contributions from our award-winning line of photo books, cards and stationery products and from our private, personalized Shutterfly Share sites. The revenue growth we have seen throughout the year, and the accelerating growth we've seen from our core personalized products, confirms that our strategy is on target and that we are continuing to delight our customers with unique, stylish and creative ways to stay connected to the people who matter most in their lives.



2010: Innovation, Execution and Financial Discipline

Throughout 2010 we made meaningful investments in key areas of our business. These investments improved our platform and storage architectures, strengthened our image rendering and ecommerce capabilities and supported new product, feature and design enhancements. We believe these investments will improve the overall customer experience, further differentiate our brand strengthen our competitive position.

The consistent execution against our key strategic initiatives, relentless focus on the customer and strong financial discipline once again resulted in record financial results for 2010. For the full year 2010, we increased net revenues by 25 percent, to a record \$308 million. This outstanding performance was once again driven by accelerating year over year growth in personalized products and services and the loyal support of our four million active customers.

We finished 2010 with solid momentum in our key product and services offerings despite a fragile economy and a competitive marketplace. Throughout the year we gained market share by focusing on the customer and making the right investments centered around innovative and design forward products and services, customer friendly policies and industry-leading quality.

2011: Expand New Technology, Product Innovations and Increase Profitability

On March 21, 2011 Shutterfly announced that it entered into an agreement to acquire Tiny Prints, Inc., a privately-held company based in Sunnyvale, CA. The transaction is subject to various closing conditions, and we currently anticipate that it will close in the second quarter of 2011. Tiny Prints operates tinyprints.com and weddingpaperdivas.com, two fast growing ecommerce brands offering stylish cards, invitations, personalized stationery and photo books.

We believe that joining forces with Tiny Prints will accelerate our cards & stationery revenue growth and contribute to an already meaningful and strategically important business unit. In addition, with its incremental scale and our combined resources, we believe we can extend the Tiny Prints brands to significantly broaden the market opportunity through the introduction of new products and services and unparalleled levels of quality and service. We are very excited because it is a very rare opportunity to bring together two companies that can dovetail brands, product offerings, technology platforms and manufacturing approaches. This truly is one of those opportunities, and we believe that meaningful revenue and cost synergies will be unlocked across all of these dimensions over the months and years ahead.

In 2011 we will continue to invest in new technology initiatives, including an enhanced image rendering architecture, proprietary tiered storage environment, marketing and analytical systems and a number of major customer-facing applications including a new custom photo book platform. We believe consistent product innovation and efficiently leveraging the benefits from scale will create the greatest long-term differentiation from competitors. This approach, combined with our commitment to solid execution and financial discipline, will help enable us to maintain our record of increased revenue, free cash flows and long-term shareholder value in 2011 and beyond.

I want to personally thank our customers for their loyalty and patronage, and our employees and partners for their tremendous contributions throughout 2010. On behalf of the Shutterfly team, I thank our stockholders for their continued support.

Sincerely,



Jeff Housenbold, CEO



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, 2010

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
(State or Other Jurisdiction of Incorporation or Organization)

94-3330068
(I.R.S. Employer Identification No.)

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

94065
(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

Smaller reporting company

(Do not check if a smaller reporting company)

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

As of June 30, 2010, 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, 2010 as reported on the NASDAQ Global Market was \$652,024,414.

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 4, 2011
Common stock, \$0.0001 par value per share	28,435,818 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 2011 Annual Meeting of the Stockholders to be held on May 25, 2011 (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.
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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 manufacture most of these items in our Charlotte, North Carolina and Phoenix, Arizona production facilities. By controlling the production process in our own 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 2010, we fulfilled 9.2 million orders to 4.1 million customers, at an average order value of \$32.88 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 Services. 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, calendars, and other photo-based merchandise. In addition, PPS also includes revenues from advertising and sponsorship activities and referral fees. Our referral fee program was discontinued effective March 31, 2010, and no referral fee revenue has been recorded subsequent to that date. We also provide website services which include our share platform called Share Sites, developed from our 2008 acquisition of Nexo Systems, Inc. PPS as a percentage of total net revenue was 71% in 2010, 66% in 2009 and 61% in 2008. 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. For example, 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. In 2010, we enabled users to access photos from new sources including: Facebook, Picasa, Share Sites and directly from personal computers, which lowers the barriers to creation of photobooks. In cards and stationery, we have introduced a wide range of premium designer greeting cards and stationery for many occasions, including holidays, baby announcements, birthdays, and weddings. For the 2010 holiday season, we offered our largest holiday collection ever with nearly 1,400 new holiday designs across all form factors. We continue to expand and enhance our Share Sites which allow users to easily create custom, personalized, private web sites for sharing with friends, family and community groups. We launched new templates, themes,

and functionality for our Share Sites designed to support new parents, brides, teachers, and coaches. In 2010 we partnered with the American Youth Soccer Organization (“AYSO”) to create Share Sites available to support over 50,000 soccer teams across the country. 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. In 2010, we partnered with Groupon to offer multiple nationwide flash promotions to more than 10 million Groupon members. We also partnered with Best Buy to promote Shutterfly products when customers purchase a qualifying digital camera or camcorder in store. We 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. In 2010, we introduced new calendar designs and form factors and unveiled a new home décor collection. 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. In 2010, we expanded our card and stationery collection to include occasions like Baptisms, summer parties, moving announcements and birthdays.

- *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. In 2010, we expanded our print-to-retail relationships and customers can now pick up 4x6 prints at their local CVS/pharmacy and Walgreens store. 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. Also included in print revenue are photocards, which are personalized silver halide photo prints with designed content, used for greeting card occasions ranging from holidays to birthday cards and thank you notes. During the last three years, our Prints revenues as a percentage of total revenues have declined to 27% in 2010, from 33% in 2009, and 39% in 2008. Despite this overall decrease, 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.

Commercial Print Services

In order to use available manufacturing capacity during low volume periods and to leverage our large installed base of digital presses, we provide commercial print services primarily to the direct marketing industry. Our commercial print revenues are derived from the printing and shipping of direct marketing and other variable data print products and formats. We continue to focus our efforts in expanding our presence in this market. For example, in November 2010, we acquired certain assets and liabilities of WMSG, Inc. to enable a complete solution for variable digital print marketers and other print-on-demand opportunities. Our commercial print revenue as a percentage of total net revenue was 2% in 2010, 1% in 2009 and 0% in 2008.

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, 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 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, Snapfish, which is a service of Hewlett-Packard, American Greetings' Photoworks and Webshots brands, Vistaprint, SmugMug, SeeHere and others;
- "Big Box" retailers such as Wal-Mart, Costco, Sam's Club 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/pharmacy and others that offer in-store pick-up from their photo website 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 digital photography marketplace;
- Photo-related software companies such as Apple, Microsoft, Corel, Picnik and FotoFlexer;
- Social media companies that host images such as MySpace, Facebook, and Twitter;
- Specialized companies in the photo book and stationery business such as Hallmark, American Greetings, Tiny Prints, Minted, Picaboo, Blurb, MyPublisher, Mixbook, MOO, Smilebox, Creative Memories and Inkubook;
- Photo hosting websites that allow users to upload and share images at no cost such as Picasa, Flickr, Photobucket and Slide; and
- Self-publishing companies and services such as Lulu, CafePress, Amazon's CreateSpace and Zazzle.

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, 2010, we had 37 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 China, the European Community, Mexico, Brazil, Japan, Australia and New Zealand. We also hold “Shutterfly.com” Internet domain registrations in the United States, Mexico, Japan, China, Australia and New Zealand, and a “Shutterfly and Design” trademark, “Tell your story,” “Shutterfly Express”, “Shutterfly Collections” “Postcards by Shutterfly”, “Shutterfly Studio”, a “Shutterfly Studio and Design”, “Picture More,” “Where your pictures live”, “Your pictures and more”, “NEXO”, “VividPics,” “Wink” and “Make one like this” service mark registrations in the United States. We also have pending applications for additional marks, including “Life Happens. Share It” and “Smart AutoFill” 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 and other states, require online services to report certain breaches of the security of personal data, and to report to consumers when their personal data might be disclosed to direct marketers.
- The federal Credit Card Accountability Responsibility and Disclosure Act of 2009 (the "CARD Act"), which was signed into law May 22, 2009, includes new provisions governing the use of gift cards, including specific disclosure requirements and a prohibition or limitation on the use of expiration dates and fees. A recent statute adopted in the State of New Jersey would enforce escheat of the entire remaining gift card balance when the card is redeemable only for goods and services and would include all gift cards sold after January 1, 2003.

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, we were a party to an Assurance of Discontinuance entered into on September 13, 2010 with the New York Attorney General's office, which related to our business

activities in New York regarding discount programs offered by Webloyalty, Inc., one of our former 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, 2010, we had 611 full time employees. Below is a summary of employees by function:

	<u>2010</u>	<u>2009</u>	<u>2008</u>
Cost of revenue	293	243	262
Technology and development	168	148	127
Sales and marketing	79	73	70
General and administrative	71	55	55
Total	<u>611</u>	<u>519</u>	<u>514</u>

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 2010, we used approximately 975 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 2010 net revenues in the fourth quarter of 2010, and the net income that we generated during the fourth quarter of 2010 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 is experiencing a slow economic recovery from a deep recession, concerns about inflation, low consumer confidence, high unemployment rate and other adverse business conditions. Fluctuations in the U.S. economy such as the recent recession 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.

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 2011 capital expenditures will range from 7.5% to 8.5% of 2011 net revenues. Operational difficulties, such as a significant interruption in the operations of either our Charlotte, North Carolina or Phoenix, Arizona production facilities 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 2010 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.

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, have negatively impacted the economy and our financial performance and may have further negative impact in the future.

Weak economic conditions, low consumer spending and decreased 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, adverse 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 and slow economic recovery or a renewed recession 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 economic recovery is slow, or if the economy experiences a prolonged period of decelerating growth, our results of operations may be further harmed.

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;
- enhance and expand our products and services;
- maintain and grow our website and customer operations;
- 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 recession, slow economic growth 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, most 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%, 14% and 17% of our net revenues in 2010, 2009 and 2008 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, Snapfish, which is a service of Hewlett-Packard, American Greetings' Photoworks and Webshots brands, Vistaprint, SmugMug, SeeHere and others;
- "Big Box" retailers such as Wal-Mart, Costco, Sam's Club 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/pharmacy and others that offer in-store pick-up from their photo website 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 digital photography marketplace;
- Photo-related software companies such as Apple, Microsoft, Corel, Picnik and FotoFlexer;
- Social media companies that host images such as MySpace, Facebook, and Twitter;
- Specialized companies in the photo book and stationery business such as Hallmark, American Greetings, Tiny Prints, Minted, Picaboo, Blurb, MyPublisher, Mixbook, MOO, Smilebox, Creative Memories and Inkubook;
- Photo hosting websites that allow users to upload and share images at no cost such as Picasa, Flickr, Photobucket and Slide; and
- Self-publishing companies and services such as Lulu, CafePress, Amazon's CreateSpace and Zazzle.

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 periods of slow economic growth and the 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.

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 have amended our 2006 Equity Incentive Plan to provide for automatic increases through 2013 of the number of shares issuable under it and we may need to grant inducement equity awards outside of the plan, which would dilute the ownership of our existing stockholders.

At the 2010 annual meeting, our stockholders approved an amendment to our 2006 Equity Incentive Plan (the “2006 Plan”) to renew its “evergreen” provision. According to the amendment, the number of shares available for issuance under the 2006 Plan will automatically increase as follows: (i) on January 1, 2011 by 3.5% of the number of the Company’s common stock issued and outstanding on December 31, 2010; (ii) on January 1, 2012 by 3.3% of the number of the Company’s common stock issued and outstanding on December 31, 2011, and (iii) on January 1, 2013 by 3.1% of the number of the Company’s common stock issued and outstanding on December 31, 2012. 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 2006 Plan, 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 2006 Plan. The increase of the shares available for issuance under the 2006 Plan and grants of awards from it, as well as further inducement equity awards outside of the 2006 Plan, 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 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, furloughs, reduced operations 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 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 2010 acquisition of WMSG, Inc., our 2009 acquisition of TinyPictures and our 2008 acquisition of Nexo. 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.

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

Our ability to successfully receive and fulfill orders and to provide high-quality customer service depends in part on the efficient and uninterrupted operation of our computer and communications systems. Substantially all of the computer hardware necessary to operate our website is located at one third-party hosting facility 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. In March 2010, we renewed our supply agreement with Fuji which expires in March 2013. If that agreement is not renewed before it expires in March 2013, 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 substantial portion 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.

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 experienced in the U.S. and worldwide. Events or weaknesses 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, 2010, we had 37 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, China, 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. For example, in 2009, we settled three patent infringement lawsuits against us. In 2010, two more patent infringement lawsuits were filed against us. On October 1, 2010, Express Card Systems, LLC filed a complaint for alleged patent infringement against us and four other defendants in the Eastern District of Texas, Tyler Division. And on December 10, 2010, Eastman Kodak Company ("Kodak") filed a complaint for alleged patent infringement against Shutterfly in the District of Delaware. 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. On December 13, 2010, we filed a patent infringement complaint against Kodak and Kodak Imaging Network, Inc. in the United States District Court for the Northern District of California. On January 31, 2011, we voluntarily dismissed that lawsuit without prejudice, and on the same day we filed a complaint in the United States District of Delaware. The new complaint asserts the same claims of infringement against Kodak.

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. 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. For example, we were a party to an Assurance of Discontinuance entered into on September 13, 2010 with the New York Attorney General's office, which related to our business activities in New York regarding discount programs offered by Webloyalty, Inc., one of our former business partners. Given the visibility of our brand, we may regularly be involved in legal proceedings, government 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 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. CARD Act limits our ability to expire gift cards. 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 established local or regional 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, acquiring or operating 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 our ability to adapt to the continued evolution 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 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, 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 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:

- slow economic growth, 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.

In 2010, we renewed the lease for our corporate headquarters in Redwood City, California in two buildings totaling approximately 100,000 square feet. This lease will expire in 2017, and we have an option to extend the lease for two additional periods of three years each. The lease provides for a \$2.1 million tenant improvement reimbursement allowance which can be utilized during the course of the lease.

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.

We maintain our west-coast production and fulfillment operations 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 October 1, 2010, Express Card Systems, LLC filed a complaint for alleged patent infringement against us and four other defendants in Express Card Systems, LLC. v. Shutterfly, Inc. et. al., Civ. No. 6:10-cv-514, in the Eastern District of Texas, Tyler Division. The complaint asserts infringement of U.S. Patent No. 5,751,590, which claims, among other things, a method related to processing images to define social expression cards in a computer database. 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. We have not yet answered or otherwise responded to the complaint.

On December 10, 2010, Eastman Kodak Company filed a complaint for alleged patent infringement against us in Eastman Kodak Company v. Shutterfly, Inc., C.A. No. 10-1079-SLR, in the U.S. District Court for the District of Delaware. The complaint asserts infringement of U.S. Patents Nos. 6,549,306; 6,600,572; 7,202,982; 6,069,712; and 6,512,570, which claim among other things, methods for selecting photographic images using index prints, an image handling system incorporating coded instructions, and processing a roll of exposed photographic film into corresponding visual prints and distributing such prints. 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. We have not yet answered or otherwise responded to the complaint.

On December 13, 2010, we filed a complaint for patent infringement against Eastman Kodak Company and Kodak Imaging Network, Inc. (“Kodak”) in *Shutterfly, Inc. v. Eastman Kodak Company and Kodak Imaging Network, Inc.*, Case No. CV 10 5672 in the U.S. District Court for the Northern District of California. The complaint asserts infringement of U.S. Patents Nos. 6,583,799; 7,269,800; 6,587,596; 6,973,222; 7,474,801; 7,016,869; and 7,395,229, which claim among other things, methods for image uploading, image cropping, automatic generation of photo albums, and changing attributes of an image-based product. The Complaint asserts that Kodak directly or indirectly infringes the patents, and it seeks unspecified damages and injunctive relief. Kodak has not yet answered or otherwise responded to the complaint. On January 31, 2011, we voluntarily dismissed that lawsuit without prejudice, and on the same day we filed a complaint in the United States District of Delaware. The new complaint asserts the same claims of infringement against Kodak.

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.

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 4, 2011, there were approximately 78 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.

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, 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
Year Ended December 31, 2010	High	Low
First Quarter	\$ 24.68	\$ 15.46
Second Quarter	\$ 25.70	\$ 19.39
Third Quarter	\$ 26.93	\$ 21.96
Fourth Quarter	\$ 36.69	\$ 23.79

Purchases of Equity Securities of the Issuer and Affiliated Purchasers

Neither we nor any affiliated purchaser repurchased any of our equity securities in fiscal year 2010.

ITEM 6. SELECTED FINANCIAL DATA.

The consolidated statements of income data for the years ended December 31, 2010, 2009 and 2008 and the consolidated balance sheet data as of December 31, 2010 and 2009 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, 2007 and 2006 and the consolidated balance sheet data as of December 31, 2008, 2007 and 2006 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,				
	2010	2009	2008	2007	2006
	(In thousands, except per share amounts)				
Consolidated Income Statement Data:					
Net revenues.....	\$ 307,707	\$ 246,432	\$ 213,480	\$ 186,727	\$ 123,353
Cost of net revenues.....	134,491	111,648	96,214	84,111	55,491
Gross profit.....	173,216	134,784	117,266	102,616	67,862
Operating expenses:					
Technology and development.....	48,393	46,003	39,707	28,822	19,087
Sales and marketing.....	59,284	44,870	42,212	33,530	21,940
General and administrative.....	40,764	35,201	32,741	29,888	19,216
Total operating expenses.....	148,441	126,074	114,660	92,240	60,243
Income from operations.....	24,775	8,710	2,606	10,376	7,619
Interest expense.....	(42)	(157)	(273)	(179)	(266)
Interest and other income, net.....	482	814	2,898	5,515	2,387
Income before income taxes.....	25,215	9,367	5,231	15,712	9,740
Provision for income taxes.....	(8,088)	(3,514)	(1,571)	(6,134)	(3,942)
Net income.....	<u>\$ 17,127</u>	<u>\$ 5,853</u>	<u>\$ 3,660</u>	<u>\$ 9,578</u>	<u>\$ 5,798</u>
Net income per share:					
Basic.....	<u>\$ 0.63</u>	<u>\$ 0.23</u>	<u>\$ 0.15</u>	<u>\$ 0.39</u>	<u>\$ 0.67</u>
Diluted.....	<u>\$ 0.59</u>	<u>\$ 0.22</u>	<u>\$ 0.14</u>	<u>\$ 0.36</u>	<u>\$ 0.56</u>
Weighted average shares					
Basic.....	27,025	25,420	25,036	24,295	8,622
Diluted.....	29,249	26,810	25,787	26,273	10,331

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

	Year Ended December 31,				
	2010	2009	2008	2007	2006
	(In thousands)				
Cost of net revenues.....	\$ 508	\$ 416	\$ 372	\$ 189	\$ 96
Technology and development.....	3,069	3,340	2,404	1,067	736
Sales and marketing.....	3,923	3,577	2,452	1,044	521
General and administration.....	8,866	6,940	4,522	2,386	947
	<u>\$ 16,366</u>	<u>\$ 14,273</u>	<u>\$ 9,750</u>	<u>\$ 4,686</u>	<u>\$ 2,300</u>

The chart below includes selected data from our balance sheet:

	2010	2009	December 31, 2008	2007	2006
	(In thousands)				
Consolidated Balance Sheet Data:					
Cash, cash equivalents, and short term investments	\$ 252,244	\$ 180,737	\$ 88,164	\$ 125,584	\$ 119,051
Property and equipment, net.....	39,726	41,845	48,108	48,416	30,919
Working capital	200,282	141,410	58,232	104,025	102,165
Total assets	343,830	271,313	233,297	208,938	180,160
Capital lease obligations, less current portion ...	6	10	17	107	1,742
Total stockholders' equity.....	269,607	215,164	186,802	170,734	151,326

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 and growth of our business, the impact on us of general economic conditions, trends in key metrics such as number of customers and orders and average order value, the decline in average selling prices for prints, our capital expenditures for 2011, the sufficiency of our cash and cash equivalents and cash generated from operations for the next 12 months, our ability to grow our personalized products and services as a percentage of our total revenues, our operating expenses remaining a consistent percentage of our net 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, greeting and stationery cards, personalized calendars, other photo-based merchandise and high-quality prints ranging in size from wallet-sized to jumbo-sized 20x30 enlargements. We manufacture most of these items in our Charlotte, North Carolina and Phoenix, Arizona production facilities. By controlling the production process in our own production 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 2010, we fulfilled 9.2 million orders, to 4.1 million customers, at an average order value of \$32.88 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.

Our operations and financial performance depend on general economic conditions. The U.S. economy is experiencing a slow economic recovery from a deep recession and concerns about that recovery could further impact consumer sentiment and consumer discretionary spending. We closely monitor these economic measures as their trends are indicators of the health of the overall economy and are some of the key external factors that impact our business.

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 were approximately 0.7%, 2.5% and 3.1% of our net annual revenues for 2010, 2009 and 2008. Our referral fee program was discontinued effective March 31, 2010, and no referral fee revenue has been recorded subsequent to that date.

Prints

We also generate revenue from photo prints and the associated shipping revenue. Photo prints consist of wallet, 2x6, 4x6, 5x7, 8x10, and large format sizes. Also included in print revenues are photocards, which are personalized silver halide photo prints with designed content, used for greeting card occasions ranging from holidays to birthday cards and thank you notes.

Commercial print services

In order to use available print capacity during low volume periods and to leverage our large installed base of existing digital presses, we began providing commercial printing services in 2008 to the direct marketing industry. We continue to focus our efforts in expanding our presence in this market. For example, in November 2010, we acquired WMSG, Inc. enabling us to provide a complete solution for variable digital print marketers and other print-on-demand opportunities.

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 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.

Total Number of Orders. We closely monitor the 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 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.

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 71% in 2010, 66% in 2009 and 61% in 2008. We believe that this trend results, in part, from the shift of consumer spending from offline to online outlets, as well as the increasing adoption of personalized, designed content.

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 and software development costs, and patent royalties. Cost of net revenues also includes certain costs associated with facility closures and restructuring.

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. We recognized a final payment due from one of the agreements 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. Our latest facility expired in June 2010 and was not renewed.

Interest and other income, net. Interest and other income, net primarily consists of the interest earned on our cash and investment accounts as well as gains and losses on our trading securities and the Right from UBS entitling us to sell at par value auction-rate securities (“ARS”) investment previously purchased from UBS. On June 30, 2010, we exercised the UBS Right to liquidate all of our ARS investments at par value. On July 1, 2010, that transaction was executed and we received proceeds of \$26.3 million, which were immediately invested in Treasury securities.

Income Taxes. We account 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. 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 generally recognize revenue from product sales, net of applicable sales tax, upon shipment of fulfilled orders, when persuasive evidence of an arrangement exists, the selling price is fixed or determinable and collection of resulting receivables is reasonably assured. Shipping charged to customers is recognized as revenue at the time of shipment.

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

For gift card sales and flash deal promotions through group buying websites, we recognize revenue when redeemed items are shipped. Revenues from sales of prepaid orders on our website are deferred until shipment of fulfilled orders or until the prepaid period expires. Our share of revenue generated from our print to retail relationships, is recognized when orders are picked up by our customers at the respective retailer.

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. The provision for estimated returns is included in accrued expenses. During the year ended December 31, 2010, 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 presented in net revenues. Production costs related to free products are included in cost of revenues upon redemption.

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 the Company's website) are delivered; as "clicks" (which are generated each time users of our 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.

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.

Goodwill and Intangible Assets. Goodwill represents the excess of the purchase price over the fair value of the net tangible and identifiable intangible assets acquired in a business combination. Intangible assets resulting from the acquisition of entities accounted for using the purchase method of accounting are estimated by management based on the fair value of assets received. Intangible assets are amortized on a straight-line basis over the estimated useful lives which range from one to sixteen years. Goodwill and intangibles assets with indefinite lives are not subject to amortization, but are tested for impairment on an annual basis during our fourth quarter or whenever events or changes in circumstances indicate the carrying amount of these assets may not be recoverable.

Software and Website Development Costs. We capitalize costs associated with website development and software developed or obtained for internal use. 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 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 report a liability for unrecognized tax benefits resulting from uncertain tax positions taken or expected to be taken in a tax return. 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 measure our stock based awards at fair value and recognize 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,		
	2010	2009	2008
Net revenues.....	100%	100%	100%
Cost of revenues	44	45	45
Gross profit.....	56	55	55
Operating expenses:			
Technology and development	16	19	19
Sales and marketing	19	18	20
General and administrative.....	13	14	15
Total operating expenses.....	48	51	54
Income from operations.....	8	4	1
Interest expense.....	0	0	0
Interest and other income, net	0	0	2
Income before income taxes.....	8	4	3
Provision for income taxes	(3)	(1)	(1)
Net income	6%	3%	2%

Comparison of the Years Ended December 31, 2010 and 2009

	Year Ended December 31,			
	2010	2009	\$ Change	% Change
	<i>(in thousands)</i>			
Net Revenues				
Personalized products and services.....	\$ 218,668	\$ 161,650	\$ 57,018	35%
Prints	83,931	80,941	2,990	4
Commercial printing services	5,108	3,841	1,267	33
Total net revenues.....	307,707	246,432	61,275	25
Cost of net revenues.....	134,491	111,648	22,843	20
Gross profit.....	\$ 173,216	\$ 134,784	\$ 38,432	29%
<i>Percentage of net revenues.....</i>	<i>56%</i>	<i>55%</i>	—	—

Net revenues increased \$61.3 million, or 25%, in 2010 compared to 2009. Revenue growth was attributable to increases in all revenue categories. PPS revenues increased \$57.0 million, or 35%, to \$218.7 million in 2010 compared to 2009. The increase in PPS is primarily a result of increased sales of photo books and greeting and stationery cards. Print revenue increased \$3.0 million, or 4%, to \$83.9 million in 2010 compared to 2009. The overall increase in print revenue was primarily due to an increase in photocard revenue offset by a decrease in 4x6 print revenue which represented 10% of total net revenues versus 14% in the prior year. In terms of product mix, PPS represented 71% and Prints represented 27% of revenue in 2010. This compares to 66% and 33% in 2009. Revenue from our commercial print initiative increased \$1.3 million, or 33%, to \$5.1 million for 2010, and represented 2% of our total net revenues.

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,			
	2010	2009	Change	% Change
	<i>(In thousands, except AOV amounts)</i>			
Customers	4,069	3,281	788	24%
Orders.....	9,204	7,891	1,313	17%
Average order value	\$ 32.88	\$ 30.74	\$ 2.14	7%

Cost of net revenues increased \$22.8 million, or 20%, in 2010 compared to 2009. As a percentage of net revenues, cost of net revenues decreased slightly from 45% in 2009 to 44% in 2010, which increased gross margin from 55% in 2009 to 56% in 2010. Overall, the increase in cost of net revenues was primarily the result of the increased volume of shipped products and increased headcount compared to 2009. These costs were partially offset by favorable improvements from product mix and labor efficiencies from both our Charlotte and Phoenix manufacturing facilities.

	Year Ended December 31,			
	2010	2009	\$ Change	% Change
	<i>(in thousands)</i>			
Technology and development	\$ 48,393	\$ 46,003	\$ 2,390	5%
<i>Percentage of net revenues</i>	<i>16%</i>	<i>19%</i>	—	—
Sales and marketing	\$ 59,284	\$ 44,870	\$ 14,414	32%
<i>Percentage of net revenues</i>	<i>19%</i>	<i>18%</i>	—	—
General and administrative.....	\$ 40,764	\$ 35,201	\$ 5,563	16%
<i>Percentage of net revenues</i>	<i>13%</i>	<i>14%</i>	—	—

Our technology and development expense increased \$2.4 million, or 5%, in 2010 compared to 2009. As a percentage of net revenues, technology and development expense decreased to 16% in 2010 from 19% for the same period in 2009. The increase in technology and development expense was primarily due to an increase of \$4.5 million related to personnel and related costs for employees and an increase of \$3.3 million related to professional and outside services consultants involved with website development and website infrastructure support teams. These factors were partially offset by a decrease in depreciation expense of \$2.1 million, a decrease of \$0.3 million in stock-based compensation and higher website development costs capitalized in the current period compared to the same period in the prior year.

During 2010, headcount in technology and development increased by 14% compared to 2009, reflecting our strategic focus to increase the rate of innovation in our product and services offerings, to generate greater differentiation from our competitors, and improve our long-term operating efficiency. As a result, in 2010, we capitalized \$7.3 million in eligible salary and consultant costs, including \$0.3 million of stock based compensation, associated with software developed or obtained for internal use, compared to \$5.4 million, which included \$1.6 million of stock based compensation capitalized, in 2009. We expect this trend to continue in 2011, further increasing capitalized website and software development costs as a percentage of our total capital expenditures.

Our sales and marketing expense increased \$14.4 million, or 32%, in 2010 compared to 2009. As a percentage of net revenues, total sales and marketing expense increased slightly from 18% in 2009 to 19% in 2010. The increase in sales and marketing expense was primarily due to an increase of \$12.2 million related to expanded online media, direct response, and partner marketing campaigns. The increase is also attributable to a \$1.8 million increase in personnel and related costs associated with the expansion of our internal marketing team and an increase of \$0.3 million in stock based compensation.

Our general and administrative expense increased \$5.6 million, or 16%, in 2010 compared to 2009, and decreased as a percentage of net revenues from 14% in 2009 to 13% in 2010. The increase in general and administrative expense is primarily due to an increase in stock based compensation of \$1.9 million and personnel related costs of \$1.8 million as a result of increased headcount. In 2010, we also incurred an increase in credit card fees of \$1.8 million which was driven by the increase in consumer product revenue as compared to the prior year. During 2009, we received two installment payments from cross-licensing agreements, whereas in the current period we received one installment payment. These payments were recognized as reductions of general and administrative expense. The overall increase in general and administrative expense was partially offset by a decrease of \$0.5 million of depreciation and gains on the disposal of certain fixed assets of \$0.7 million.

	Year Ended December 31,		
	2010	2009	Change
	<i>(in thousands)</i>		
Interest expense	\$ (42)	\$ (157)	\$ (115)
Interest and other income, net	\$ 482	\$ 814	\$ (332)

Interest expense decreased by \$0.1 million or 73% for 2010 compared to 2009 primarily due to the expiration of our \$20.0 million line of credit facility with Silicon Valley Bank on June 23, 2010, which was not renewed.

Interest and other income, net decreased by \$0.3 million for 2010 compared to 2009. The decrease was primarily due to the liquidation of our ARS investments on July 1, 2010, which yielded higher returns and were subsequently invested in Treasury securities, which yielded lower returns.

	Year Ended December 31,	
	2010	2009
	<i>(in thousands)</i>	
Income tax provision	\$ (8,088)	\$ (3,514)
Effective tax rate	32%	38%

The provision for income taxes was \$8.1 million for 2010, compared to a provision of \$3.5 million for 2009. Our effective tax rate was 32% in 2010, down from 38% in 2009. This decrease in our effective tax rate is primarily the result of disqualifying dispositions of incentive stock option awards.

At December 31, 2010, we had approximately \$32.7 million of state net operating loss carryforwards to reduce future regular taxable income, of which \$10.3 million is associated with windfall tax benefits that will be recorded as additional paid-in capital when realized. These carryforwards will expire beginning in 2016, if not utilized. We recognized the remaining federal net operating loss carryforward in 2010, except for federal net operating losses associated with our acquisition of TinyPictures in the amount of \$1.5 million.

	Year Ended December 31,			
	2010	2009	\$ Change	% Change
	<i>(in thousands)</i>			
Income before income taxes	\$ 25,215	\$ 9,367	\$ 15,848	169%
Net income	\$ 17,127	\$ 5,853	\$ 11,274	193%
<i>Percentage of net revenues</i>	6%	3%	—	—

Net income increased by \$11.3 million, or 193%, from 2009 to 2010. As a percentage of net revenue, net income was 6% of net revenue for 2010 compared to 3% for 2009.

Comparison of the Years Ended December 31, 2009 and 2008

	Year Ended December 31,			
	2009	2008	\$ Change	% Change
	<i>(in thousands)</i>			
Net revenues				
Personalized products and services	\$ 161,650	\$ 129,523	\$ 32,127	25%
Prints	80,941	83,609	(2,668)	(3)
Commercial printing services	3,841	348	3,493	1004
Total net revenues	246,432	213,480	32,952	15
Cost of net revenues	111,648	96,214	15,434	16
Gross profit	\$ 134,784	\$ 117,266	\$ 17,518	15%
<i>Percentage of net revenues</i>	55%	55%	—	—

Net revenues increased \$33.0 million, or 15%, in 2009 compared to 2008. Revenue growth was primarily 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. Print revenue decreased \$2.7 million, or 3%, to \$80.9 million in 2009 compared to 2008. 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. In terms of product mix, PPS represented 66% and Prints represented 33% of revenue in 2009. This compares to 61% and 39% in 2008. Revenue from our commercial print initiative totaled \$3.8 million for 2009, and represented 1% of our total net revenues.

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
	<i>(in thousands, except AOV amounts)</i>			
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 production facility to our new Phoenix production 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
	<i>(in thousands)</i>			
Technology and development	\$ 46,003	\$ 39,707	\$ 6,296	16%
<i>Percentage of net revenues</i>	<i>19%</i>	<i>19%</i>	—	—
Sales and marketing	\$ 44,870	\$ 42,212	\$ 2,658	6%
<i>Percentage of net revenues</i>	<i>18%</i>	<i>20%</i>	—	—
General and administrative	\$ 35,201	\$ 32,741	\$ 2,460	8%
<i>Percentage of net revenues</i>	<i>14%</i>	<i>15%</i>	—	—

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. Also 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.

	<u>Year Ended December 31,</u>		
	<u>2009</u>	<u>2008</u>	<u>Change</u>
	<i>(in thousands)</i>		
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.

	<u>Year Ended December 31,</u>	
	<u>2009</u>	<u>2008</u>
	<i>(in thousands)</i>	
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.

As of 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.

	<u>Year Ended December 31,</u>			
	<u>2009</u>	<u>2008</u>	<u>\$ Change</u>	<u>% Change</u>
	<i>(in thousands)</i>			
Income before income taxes	\$ 9,367	\$ 5,231	\$ 4,136	79%
Net income	\$ 5,853	\$ 3,660	\$ 2,193	60%
<i>Percentage of net revenues</i>	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.

Liquidity and Capital Resources

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

	<u>December 31,</u>	
	<u>2010</u>	<u>2009</u>
Cash and cash equivalents	\$ 252,244	\$ 132,812
Auction Rate Securities and Rights	-	47,925
Total Capital Resources	<u>\$ 252,244</u>	<u>\$ 180,737</u>

At December 31, 2010, we had \$252.2 million of cash and cash equivalents. In January 2008, we purchased ARS investment held with UBS AG (“UBS”), one of our investment providers. Since inception in 2008 and due to uncertainties in the credit markets, all scheduled auctions began to fail and the investments were illiquid resulting in Level 3 financial asset classification. In November 2008, we accepted an offer (the “Right”) from UBS 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. On June 30, 2010, we exercised the Right to liquidate all of our ARS investments at par value. On July 1, 2010, that transaction was executed and we received proceeds of \$26.3 million, which were immediately invested in Treasury securities. With increased liquidity resulting from the ARS redemption, we elected not to renew the \$20.0 million line of credit facility with Silicon Valley Bank that expired on June 23, 2010.

Below is our cash flow activity for the years ended December 31, 2010, 2009 and 2008:

	<u>Year Ended December 31,</u>		
	<u>2010</u>	<u>2009</u>	<u>2008</u>
	<i>(in thousands)</i>		
Consolidated Statement of Cash Flows Data:			
Purchases of property and equipment	\$ 14,405	\$ 13,762	\$ 18,220
Capitalization of software and website development costs	7,405	3,891	4,527
Acquisition of business and intangibles, net of cash acquired	5,981	795	10,097
Depreciation and amortization	25,972	27,194	26,038
Cash flows from operating activities	76,161	53,890	47,040
Cash flows provided by (used in) investing activities	22,610	(14,123)	(82,086)
Cash flows from financing activities	20,661	4,881	628

We anticipate that our current cash and cash equivalents balances and cash generated from operations will be sufficient to meet our strategic and working capital requirements, 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 2011 capital expenditures will range from 7.5% to 8.5% of our expected net revenues in 2011. 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. An increasing component of these expenditures includes costs associated with capitalized software and website development, as we continue to support our innovative engineering and product development strategies. 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.

The following table shows total capital expenditures by category for fiscal years 2010, 2009 and 2008 (in thousands):

	<u>Year Ended December 31,</u>		
	<u>2010</u>	<u>2009</u>	<u>2008</u>
Technology equipment and software	\$ 11,585	\$ 8,409	\$ 13,200
<i>Percentage of total capital expenditures</i>	<i>52%</i>	<i>48%</i>	<i>58%</i>
Manufacturing equipment and building improvements	3,376	5,355	5,020
<i>Percentage of total capital expenditures</i>	<i>15%</i>	<i>30%</i>	<i>22%</i>
Capitalized technology and development costs	7,405	3,891	4,527
<i>Percentage of total capital expenditures</i>	<i>33%</i>	<i>22%</i>	<i>20%</i>
Total Capital Expenditures	<u>\$ 22,366</u>	<u>\$ 17,655</u>	<u>\$ 22,747</u>
<i>Total Capital Expenditures percentage of Net revenues ...</i>	<i>7%</i>	<i>7%</i>	<i>11%</i>

Our capital expenditures have decreased as a percentage of net revenues, to 7% in 2010 from 11% in 2008. In addition, during this same period, the percentage of total capital expenditures associated with website and product development has increased, to 33% in 2010 from 20% in 2008. During 2011, we expect that this trend will continue as we add more headcount to our technology and development function consistent with our strategic focus to increase the rate of innovation in our product and services offerings, to generate greater differentiation from our competitors, and improve our long-term operating efficiency.

Also during 2011, we expect to incur additional capital expenditures associated with building improvements we are making to our headquarters facility. Our new lease agreement provides for a \$2.1 million tenant improvement reimbursement allowance. Reimbursements under this provision will be recorded as a deferred lease incentive and will reduce rent expense over the remaining lease term. We expect to utilize the entire reimbursement allowance during 2011.

We also expect that capital expenditures associated with our manufacturing equipment and facilities will moderate as a percentage of our total capital expenditures. This is partially due to our efforts to provide the highest quality products through use of rapidly increasing digital press technology. Because of these technology increases, we have migrated some of our older press platforms from owned equipment to operating leases. Specifically, in 2010, we entered into multiple non-cancellable operating leases for new digital presses with terms that expire in five years. These leases provide greater flexibility to upgrade this equipment in the future, and to keep pace with increasing digital technology.

Operating Activities. For 2010, net cash provided by operating activities was \$76.2 million, primarily due to our net income of \$17.1 million and the net change in operating assets and liabilities of \$15.0 million, adjusted for non-cash items including \$26.0 million of depreciation and amortization expense, \$2.0 million benefit from deferred income taxes, and \$16.4 million of stock-based compensation.

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.

Investing Activities. For 2010, net cash provided by investing activities was \$22.6 million due to the liquidation of \$47.9 million (at par value) of our remaining ARS investments as a result of exercising the UBS Right and \$2.5 million proceeds from the sale of fixed assets. This increase was offset by \$14.4 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 \$7.4 million of capitalized software and website development. We also paid \$5.8 million in cash to acquire WMSG, Inc. and \$0.2 million to settle an escrow liability related to our TinyPictures acquisition in 2009.

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.

Financing Activities. For 2010, net cash provided by financing activities was \$20.7 million, primarily from \$14.7 million of proceeds from issuance of common stock upon exercise of stock options and \$6.0 million excess tax benefit from stock-options.

Our 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.

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 profitability and liquidity that, when viewed with our GAAP results, provides a more complete understanding of factors and trends affecting our earnings and cash flows. Refer below for a reconciliation of both adjusted EBITDA and free cash flow to the most comparable 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 net revenues over fiscal years 2010, 2009, and 2008 (in thousands):

	<u>Year Ended December 31,</u>		
	<u>2010</u>	<u>2009</u>	<u>2008</u>
Revenue	\$ 307,707	\$ 246,432	\$ 213,480
Non-GAAP Adjusted EBITDA	67,113	50,177	38,394
<i>EBITDA percentage of Net revenues</i>	22%	20%	18%
Free cash flow	44,747	32,522	15,647
<i>Free cash flow percentage of Net revenues</i>	15%	13%	7%

We carefully manage our operating costs and capital expenditures, in order to make the strategic investments necessary to grow and strengthen our business, while at the same time increasing our adjusted EBITDA profitability and improving our free cash flows. Over the last three years, our full year adjusted EBITDA profitability rate has improved to 22% in 2010 from 20% in 2009 and 18% in 2008. This continued growth in adjusted EBITDA profitability resulted from increased demand for our products and services, improvements from product mix and consistent efforts to manage our cost structure in line with our revenue growth. We also increased our free cash flow from 7% of net revenues in 2008 to 15% in 2010.

The following is a reconciliation of adjusted EBITDA and free cash flow to the most comparable GAAP measure for the years ended December 31, 2010, 2009 and 2008 (in thousands):

Reconciliation of Net Income to Non-GAAP Adjusted EBITDA

	<u>Year Ended December 31,</u>		
	<u>2010</u>	<u>2009</u>	<u>2008</u>
Net income	\$ 17,127	\$ 5,853	\$ 3,660
Add back:			
Interest expense	42	157	273
Interest and other income, net	(482)	(814)	(2,898)
Tax provision	8,088	3,514	1,571
Depreciation and amortization	25,972	27,194	26,038
Stock-based compensation expense	16,366	14,273	9,750
Non-GAAP Adjusted EBITDA	<u>\$ 67,113</u>	<u>\$ 50,177</u>	<u>\$ 38,394</u>

Reconciliation of Cash Flow from Operating Activities to Non-GAAP Adjusted EBITDA and Free Cash Flow

	<u>Year Ended December 31,</u>		
	<u>2010</u>	<u>2009</u>	<u>2008</u>
Net cash provided operating activities	\$ 76,161	\$ 53,890	\$ 47,040
Add back:			
Interest expense	42	157	273
Interest and other income, net	(482)	(814)	(2,898)
Tax provision	8,088	3,514	1,571
Changes in operating assets and liabilities	(15,014)	(7,435)	(7,978)
Other adjustments	(1,682)	865	386
Non-GAAP Adjusted EBITDA	<u>\$ 67,113</u>	<u>\$ 50,177</u>	<u>\$ 38,394</u>
Less:			
Purchases of property and equipment, including accrued amounts	(14,961)	(13,764)	(18,220)
Capitalized technology and development costs	(7,405)	(3,891)	(4,527)
Free cash flow	<u>\$ 44,747</u>	<u>\$ 32,522</u>	<u>\$ 15,647</u>

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.

Contractual Obligations

We lease office space in Redwood City, California and a production facility in Charlotte, North Carolina and Phoenix, Arizona under non-cancelable operating leases that expire in 2017, 2014, and 2016, respectively. We have co-location agreements with third-party hosting facilities that expire in 2013. We also have various non-cancellable operating leases for certain production equipment. Specifically, in 2010, we entered into multiple non-cancellable operating leases for new digital presses with terms that expire in five years. 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, 2010, associated with lease obligations and other arrangements:

	<u>Total</u>	<u>Less Than 1 Year</u>	<u>1-3 Years (In thousands)</u>	<u>3-5 Years</u>	<u>More Than 5 Years</u>
Contractual Obligations					
Operating lease obligations.....	\$ 32,546	\$ 5,820	\$ 19,069	\$ 6,902	\$ 755
Purchase obligations.....	16,127	7,954	8,173	—	—
Total contractual obligations	<u>\$ 48,673</u>	<u>\$ 13,774</u>	<u>\$ 27,242</u>	<u>\$ 6,902</u>	<u>\$ 755</u>

The table above excludes the impact of approximately \$3.0 million related to unrecognized tax benefits as of December 31, 2010. We 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

Effective January 1, 2010, we adopted revised guidance issued by the Financial Accounting Standards Board ("FASB") that was intended to improve disclosures related to fair value measurements. This guidance requires us to separate information about significant transfers in and out of Level 1 and Level 2 and the reason for such transfers, and also requires information related to purchases, sales, issuances, and settlements of Level 3 financial assets to be included in the rollforward of activity. The guidance also requires us to provide certain disaggregated information on the fair value of financial assets and requires us to disclose valuation techniques and inputs used for both recurring and nonrecurring fair value measurements of our Level 2 and Level 3 financial assets. We have provided the additional required disclosures effective January 1, 2010.

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.

On June 30, 2010, we exercised the UBS Right to liquidate our ARS investments at par value. On July 1, 2010, that transaction was executed, and we received proceeds of \$26.3 million, which were immediately invested in Treasury securities. As a result of this liquidation, we are no longer subject to the unique market risk associated with these investments and the Right.

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.
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Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders of Shutterfly Inc.

In our opinion, the consolidated balance sheets and the related consolidated statements of income, shareholders equity, comprehensive income, and cash flows present fairly, in all material respects, the financial position of Shutterfly Inc, and its subsidiaries at December 31, 2010 and December 31, 2009, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2010 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, 2010, 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. 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.

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 7, 2011

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

	December 31,	
	2010	2009
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 252,244	\$ 132,812
Short-term investments	—	47,925
Accounts receivable, net	4,845	5,472
Inventories	3,580	2,968
Deferred tax asset, current portion	3,582	2,243
Prepaid expenses and other current assets	6,934	4,501
Total current assets	271,185	195,921
Property and equipment, net	39,726	41,845
Goodwill and intangible assets, net	16,835	13,406
Deferred tax asset, net of current portion	11,314	14,674
Other assets	4,770	5,467
Total assets	\$ 343,830	\$ 271,313
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 22,341	\$ 13,116
Accrued liabilities	38,831	32,793
Deferred revenue	9,731	8,602
Total current liabilities	70,903	54,511
Other liabilities	3,320	1,638
Total liabilities	74,223	56,149
Commitments and contingencies (Note 6)		
Stockholders' equity:		
Common stock, \$0.0001 par value; 100,000 shares authorized; 27,957 and 25,909 shares issued and outstanding at December 31, 2010 and December 31, 2009, respectively	3	3
Additional paid-in capital	263,726	226,410
Accumulated earnings (deficit)	5,878	(11,249)
Total stockholders' equity	269,607	215,164
Total liabilities and stockholders' equity	\$ 343,830	\$ 271,313

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

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

	<u>Year Ended December 31,</u>		
	<u>2010</u>	<u>2009</u>	<u>2008</u>
Net revenues.....	\$ 307,707	\$ 246,432	\$ 213,480
Cost of net revenues.....	134,491	111,648	96,214
Gross profit.....	<u>173,216</u>	<u>134,784</u>	<u>117,266</u>
Operating expenses:			
Technology and development.....	48,393	46,003	39,707
Sales and marketing.....	59,284	44,870	42,212
General and administrative.....	40,764	35,201	32,741
Total operating expenses.....	<u>148,441</u>	<u>126,074</u>	<u>114,660</u>
Income from operations.....	24,775	8,710	2,606
Interest expense.....	(42)	(157)	(273)
Interest and other income, net.....	482	814	2,898
Income before income taxes.....	25,215	9,367	5,231
Provision for income taxes.....	(8,088)	(3,514)	(1,571)
Net income.....	<u>\$ 17,127</u>	<u>\$ 5,853</u>	<u>\$ 3,660</u>
Net income per share:			
Basic.....	\$ 0.63	\$ 0.23	\$ 0.15
Diluted.....	<u>\$ 0.59</u>	<u>\$ 0.22</u>	<u>\$ 0.14</u>
Weighted average shares:			
Basic.....	<u>27,025</u>	<u>25,420</u>	<u>25,036</u>
Diluted.....	<u>29,249</u>	<u>26,810</u>	<u>25,787</u>
Stock-based compensation is allocated as follows (Notes 2 and 7):			
Cost of net revenues.....	\$ 508	\$ 416	\$ 372
Technology and development.....	3,069	3,340	2,404
Sales and marketing.....	3,923	3,577	2,452
General and administrative.....	8,866	6,940	4,522

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

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

	<u>Year Ended December 31,</u>		
	<u>2010</u>	<u>2009</u>	<u>2008</u>
Common stock (par value)			
Balance, beginning of year	\$ 3	\$ 2	\$ 2
Issuance of common stock upon exercise of options and vesting of restricted stock units	<u>—</u>	<u>1</u>	<u>—</u>
Balance, end of year	<u>3</u>	<u>3</u>	<u>2</u>
Additional paid-in capital			
Balance, beginning of year	226,410	203,902	191,534
Issuance of common stock upon exercise of options and vesting of restricted stock units	14,703	1,699	899
Stock based compensation, net of estimated forfeiture	16,640	15,844	11,313
Tax benefit of stock options	5,973	4,965	156
Balance, end of year	<u>263,726</u>	<u>226,410</u>	<u>203,902</u>
Deferred stock-based compensation			
Balance, beginning of year	—	—	(28)
Amortization of deferred stock-based compensation, net of cancellations	<u>—</u>	<u>—</u>	<u>28</u>
Balance, end of year	<u>—</u>	<u>—</u>	<u>—</u>
Accumulated earnings (deficit)			
Balance, beginning of year	(11,249)	(17,102)	(20,762)
Net income	17,127	5,853	3,660
Balance, end of year	<u>5,878</u>	<u>(11,249)</u>	<u>(17,102)</u>
Accumulated other comprehensive loss			
Balance, beginning of year	—	—	(12)
Change in unrealized loss in investments, net of tax	<u>—</u>	<u>—</u>	<u>12</u>
Balance, end of year	<u>—</u>	<u>—</u>	<u>—</u>
Total stockholders' equity	<u>\$ 269,607</u>	<u>\$ 215,164</u>	<u>\$ 186,802</u>
Number of shares			
Common stock			
Balance, beginning of year	25,909	25,138	24,805
Issuance of common stock upon exercise of options and vesting of restricted stock units	2,048	771	333
Balance, end of year	<u>27,957</u>	<u>25,909</u>	<u>25,138</u>

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

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

	<u>Year Ended December 31,</u>		
	<u>2010</u>	<u>2009</u>	<u>2008</u>
Net income	\$ 17,127	\$ 5,853	\$ 3,660
Unrealized gain on investments, net of tax			
Unrealized loss arising during period	—	—	(5,846)
Less: reclassification adjustment for gain realized in net income	—	—	5,858
Total comprehensive income	<u>\$ 17,127</u>	<u>\$ 5,853</u>	<u>\$ 3,672</u>

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,		
	2010	2009	2008
Cash flows from operating activities:			
Net income	\$ 17,127	\$ 5,853	\$ 3,660
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	23,429	25,122	24,211
Amortization of intangible assets	2,543	2,072	1,827
Stock-based compensation, net of forfeitures.....	16,366	14,273	9,750
Loss/(gain) on disposal of property and equipment.....	(345)	346	308
Deferred income taxes	2,021	(2,903)	(312)
Tax benefit from stock-based compensation	5,973	4,965	156
Excess tax benefits from stock-based compensation.....	(5,967)	(3,273)	(538)
Loss/(gain) on auction rate securities	(6,266)	2,747	(9,013)
Loss/(gain) on auction rate securities	6,266	(2,747)	9,013
Changes in operating assets and liabilities:			
Accounts receivable, net	688	520	(1,512)
Inventories	(558)	642	1,178
Prepaid expenses and other current assets	(2,402)	501	(120)
Other assets	2	(3,282)	(243)
Accounts payable	8,652	1,947	2,431
Accrued and other liabilities	7,504	7,966	5,482
Deferred revenue	1,128	(859)	762
Net cash provided by operating activities.....	76,161	53,890	47,040
Cash flows from investing activities:			
Purchases of property and equipment	(14,405)	(13,762)	(18,220)
Capitalization of software and website development costs.....	(7,405)	(3,891)	(4,527)
Acquisition of business and intangibles, net of cash acquired	(5,981)	(795)	(10,097)
Proceeds from sale of short term investments	-	-	3,002
Proceeds from sale of equipment	2,476	-	6
Purchase of auction rate securities	-	-	(52,250)
Proceeds from the sale of auction rate securities	47,925	4,325	-
Net cash provided by (used in) investing activities	22,610	(14,123)	(82,086)
Cash flows from financing activities:			
Principal payments of capital lease obligations	(9)	(91)	(808)
Proceeds from issuance of common stock upon exercise of stock options	14,703	2,740	1,158
Shares withheld for payment of employee's withholding tax liability	-	(1,041)	(260)
Excess tax benefits from stock-based compensation	5,967	3,273	538
Net cash provided by financing activities.....	20,661	4,881	628
Net increase/(decrease) in cash and cash equivalents	119,432	44,648	(34,418)
Cash and cash equivalents, beginning of period	132,812	88,164	122,582
Cash and cash equivalents, end of period.....	\$ 252,244	\$ 132,812	\$ 88,164
Supplemental disclosures of cash flow information:			
Cash paid during the period for:			
Interest.....	\$ 1	\$ 12	\$ 47
Income taxes	663	2,644	535
Supplemental schedule of non-cash investing activities:			
Accrued acquisition liabilities	-	-	400
Net change in accrued purchases of property and equipment	556	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 photo books, greeting cards and stationery and calendars. 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, useful lives, excess and obsolete inventories, restructuring, and legal contingencies. Actual results could differ from these estimates.

Cash and Cash Equivalents

The Company considers all highly liquid investments purchased with original maturities 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 of money market funds, primarily invested in U.S. Treasury and U.S. agency securities.

Short Term Investments

The Company reports its investments at fair value and assesses whether any impairment loss exists due to declines in fair value or other market conditions. In 2009, the Company held auction rate securities (“ARS”) that were classified as trading securities, which were recorded as short term investments at December 31, 2009. Investments that the Company designates as trading assets are reported at fair value and gains or losses resulting from changes in fair value are recognized in earnings. In 2010, all auction rate securities were liquidated, and the Company no longer held any short term investments.

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:

SHUTTERFLY, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (Continued)

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.

Concentration of Credit Risk

Financial instruments that potentially subject the Company to credit risk consist principally of cash, cash equivalents, and accounts receivable. As of December 31, 2010, 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 services, 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 card 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, 2010, three customers accounted for 16%, 12% and 11% of the Company's net accounts receivable. As of December 31, 2009, two customers accounted for 38% and 14% 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 capitalize eligible costs associated with website development and software developed or obtained for internal use. 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.

SHUTTERFLY, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (Continued)

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. 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

Goodwill represents the excess of the purchase price over the fair value of the net tangible and identifiable intangible assets acquired in a business combination. Intangible assets resulting from the acquisition of entities accounted for using the purchase method of accounting are estimated by management based on the fair value of assets received. Intangible assets are amortized on a straight-line basis over the estimated useful lives which range from one to sixteen years. Goodwill and intangibles assets with indefinite lives are not subject to amortization, but are tested for impairment on an annual basis during the Company's fourth quarter or whenever events or changes in circumstances indicate the carrying amount of these assets may not be recoverable.

For the Company's annual goodwill impairment 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, 2010 and 2009.

Intellectual Property Prepaid Royalties

The Company has 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.

Revenue Recognition

The Company generally recognizes revenue from product sales, net of applicable sales tax, upon shipment of fulfilled orders, when persuasive evidence of an arrangement exists, the selling price is fixed or determinable and collection of resulting receivables is reasonably assured. 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.

For gift card sales and flash deal promotions through group buying websites, the Company recognizes revenue when redeemed items are shipped. Revenues from sales of prepaid orders on its website are deferred until shipment of fulfilled orders or until the prepaid period expires. The Company's share of revenue generated from its print to retail relationships, is recognized when orders are picked up by its customers at the respective retailer.

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.

SHUTTERFLY, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (Continued)

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 our 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

The Company records restructuring costs when expenses are 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, 2010 and December 31, 2009. Total advertising costs are included in selling and marketing expenses and totaled approximately \$15,849,000, \$14,576,000 and \$14,740,000 during the years ended December 31, 2010, 2009 and 2008, respectively.

Stock-Based Compensation

The Company measures stock based awards at fair value and recognizes compensation expense for all share-based payment awards made to its employees and directors, including employee stock options and restricted stock awards.

The Company estimates the fair value of stock options granted using the Black-Scholes valuation model. This model requires the Company 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 the Company's 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.

SHUTTERFLY, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (Continued)

Income Taxes

The Company uses the 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. Valuation allowances are established when necessary to reduce deferred tax assets to the amounts expected to be realized.

The Company reports a liability for unrecognized tax benefits resulting from uncertain tax positions taken or expected to be taken in a tax return. 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 December 31, 2009 and 2010.

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,		
	2010	2009	2008
	<i>In thousands, except per share amounts</i>		
Net income per share:			
Numerator			
Net income.....	\$ 17,127	\$ 5,853	\$ 3,660
Denominator			
Weighted-average common shares outstanding.....	27,025	25,420	25,038
Less: Weighted-average unvested common shares subject to repurchase.....	-	-	(2)
Denominator for basic net income per share.....	27,025	25,420	25,036
Dilutive effect of stock options, restricted awards and shares subject to repurchase.....	2,224	1,390	751
Denominator for diluted net income per share.....	29,249	26,810	25,787
Net income per share			
Basic.....	\$ 0.63	\$ 0.23	\$ 0.15
Diluted.....	\$ 0.59	\$ 0.22	\$ 0.14

SHUTTERFLY, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (Continued)

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

	Year Ended December 31,		
	2010	2009	2008
Stock options, restricted stock units, and shares subject to repurchase . .	830	2,559	4,230

Comprehensive Income

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 on investments for the years ended December 31, 2010, 2009 and 2008 are net of tax benefit of \$0, \$0 and \$3,148,000 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. The Company reports as a single operating segment with the Chief Executive Officer (“CEO”) being the Company’s chief operating decision maker. The Company’s CEO reviews financial information presented on a consolidated basis for purposes of allocating resources and evaluating financial performance. Accordingly, 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.

Recent Accounting Pronouncements

Effective January 1, 2010, the Company adopted revised guidance issued by the Financial Accounting Standards Board (“FASB”) that was intended to improve disclosures related to fair value measurements. This guidance requires the Company to separate information about significant transfers in and out of Level 1 and Level 2 and the reason for such transfers, and also requires information related to purchases, sales, issuances, and settlements of Level 3 financial assets to be included in the rollforward of activity. The guidance also requires the Company to provide certain disaggregated information on the fair value of financial assets and requires the Company to disclose valuation techniques and inputs used for both recurring and nonrecurring fair value measurements of our Level 2 and Level 3 financial assets. The Company has provided the additional required disclosures effective January 1, 2010.

Note 3 – Fair Value Measurement

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

	December 31, 2010			December 31, 2009		
	Cost	Recognized Gains / (Losses) included in earnings	Fair Value	Cost	Recognized Gains / (Losses) included in earnings	Fair Value
Cash Equivalents						
Money Market Funds . . .	\$ 211,385	\$ —	\$ 211,385	\$ 113,966	\$ —	\$ 113,966
Total Cash Equivalents . . .	211,385	—	211,385	113,966	—	113,966
Auction Rate Securities . . .	—	—	—	47,925	(6,266)	41,659
Rights from UBS	—	—	—	—	6,266	6,266
Total Cash Equivalents and Investments	\$ 211,385	\$ —	\$ 211,385	\$ 161,891	\$ —	\$ 161,891

SHUTTERFLY, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (Continued)

In January 2008, the Company purchased Auction Rate Securities (“ARS”) investment held with UBS AG (“UBS”), one of the Company’s investment providers. Since inception in 2008 and due to uncertainties in the credit markets, all scheduled auctions began to fail and the investments were illiquid resulting in Level 3 financial asset classification. In November 2008, the Company accepted an offer (the “Right”) from UBS entitling the Company to sell at par value ARS purchased from UBS at anytime during a two-year period from June 30, 2010 through July 2, 2012. On June 30, 2010, the Company exercised the Right to liquidate its remaining ARS investments at par value. On July 1, 2010, that transaction was executed and the Company received proceeds of \$26.3 million, which were immediately invested in Treasury securities. As of December 31, 2010, the Company only held Level 1 financial assets which were all invested in money market funds, primarily in U.S. Treasury and U.S. agency securities.

The following table provides a summary of activity related to the Company’s ARS investments and the Right (in thousands):

	<u>Rights</u>	<u>ARS</u>
Balance at December 31, 2009	\$ 6,266	\$ 41,659
Sales of ARS investments	—	(47,925)
Recognized gain/(loss) included in earnings (Interest and other income, net) ...	(6,266)	6,266
Balance at December 31, 2010	<u>\$ —</u>	<u>\$ —</u>

Note 4 — Balance Sheet Components

Intellectual Property Prepaid Royalties

Total amortization for these license agreements in 2010 and 2009 were \$694,000 and \$234,000, respectively. As of December 31, 2010, the Company had a balance of \$4.8 million in unamortized prepaid royalties. Amortization of these licenses is estimated as follows (in thousands):

Year Ending:	
2011	\$ 730
2012	730
2013	730
2014	730
2015	498
Thereafter	<u>1,370</u>
	<u>\$ 4,788</u>

Property and Equipment

	<u>December 31,</u>	
	<u>2010</u>	<u>2009</u>
	<i>In thousands</i>	
Computer and other equipment	\$ 87,531	\$ 84,754
Software	9,124	7,122
Leasehold improvements	7,133	6,848
Furniture and fixtures	3,006	2,956
Capitalized software and website development costs	<u>25,173</u>	<u>17,494</u>
	131,967	119,174
Less: Accumulated depreciation and amortization	<u>(92,241)</u>	<u>(77,329)</u>
Net property and equipment	<u>\$ 39,726</u>	<u>\$ 41,845</u>

Property and equipment includes \$35,000 and \$1,212,000 of equipment under capital leases at December 31, 2010 and 2009, respectively. Accumulated depreciation of assets under capital leases totaled \$31,000 and \$1,199,000 at December 31, 2010 and 2009, respectively.

SHUTTERFLY, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (Continued)

Depreciation and amortization expense for the years ended December 31, 2010, 2009 and 2008 was \$23,429,000, \$25,122,000 and \$24,211,000, respectively.

Total capitalized software and website development costs, net of accumulated amortization totaled \$11,588,000 and \$8,629,000 at December 31, 2010 and 2009, respectively. These amounts included \$1,846,000 and \$1,571,000 of stock based compensation expense at December 31, 2010 and 2009, respectively. Amortization of capitalized costs totaled approximately \$4,207,000, \$3,314,000 and \$2,456,000 for the years ended December 31, 2010, 2009 and 2008, respectively.

Intangible Assets

Intangible assets are comprised of the following at December 31:

	Weighted Average Useful Life	December 31,	
		2010	2009
<i>In thousands</i>			
Purchased technology	7 Years	\$ 9,878	\$ 8,578
Less: accumulated amortization		(5,228)	(3,734)
		<u>4,650</u>	<u>4,844</u>
Customer relationships	3 Years	1,935	1,015
Less: accumulated amortization		(1,065)	(777)
		<u>870</u>	<u>238</u>
Licenses and other	3 Years	416	256
Less: accumulated amortization		(264)	(200)
		<u>152</u>	<u>56</u>
Total		<u>\$ 5,672</u>	<u>\$ 5,138</u>

Purchased technology is amortized over a period ranging from two 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, 2010, 2009 and 2008 was \$1,849,000, \$1,838,000 and \$1,827,000, respectively. Amortization of existing intangible assets is estimated to be as follows (in thousands):

Year Ending:	
2011	\$ 2,104
2012	1,951
2013	644
2014	388
2015	345
Thereafter	<u>240</u>
	<u>\$ 5,672</u>

SHUTTERFLY, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (Continued)

Goodwill

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

Balance, December 31, 2008	\$ 7,724
Acquisition of business	544
Goodwill adjustments	-
Balance, December 31, 2009	<u>8,268</u>
Acquisition of business	2,895
Goodwill adjustments	-
Balance, December 31, 2010	<u><u>\$ 11,163</u></u>

Accrued Liabilities

	December 31,	
	2010	2009
	<i>In thousands</i>	
Accrued marketing expenses	\$ 11,766	\$ 10,548
Accrued production costs	8,551	7,241
Accrued income and sales taxes	7,342	5,517
Accrued compensation.....	5,701	5,227
Accrued purchases	1,313	1,228
Accrued other.....	4,158	3,032
	<u>\$ 38,831</u>	<u>\$ 32,793</u>

Note 5 — Acquisitions

WMSG, Inc.

On November 5, 2010, the Company acquired certain assets and liabilities of WMSG, Inc. (“WMSG”) for a total aggregate purchase price of \$6.0 million. This acquisition enabled the Company to provide a complete solution for variable digital print marketers and other print-on-demand opportunities. WMSG was a privately-held, digital direct marketing specialist with strong data management and marketing analytics capabilities located in Dallas, Texas. The acquisition was accounted for as a purchase transaction and accordingly, the purchase price was allocated to tangible assets acquired 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 total aggregate purchase price of \$6.0 million was comprised of \$5.8 million cash consideration, net of \$0.2 million cash acquired. The Company recorded the assets acquired at fair value at the date of acquisition. The adjusted purchase price was allocated to tangible assets of \$0.6 million and intangible assets of \$2.4 million which was comprised of \$1.3 million in developed core technology, \$0.9 million in customer relationships and \$0.2 million in non-compete agreements. The intangible assets will be amortized over their estimated useful lives ranging from two to five years. The remaining excess purchase price of approximately \$2.9 million was allocated to goodwill. The results of operations for WMSG 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, 2010.

SHUTTERFLY, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (Continued)

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.

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 6 — Commitments and Contingencies

Leases

The Company leases office and production space under various non-cancelable operating leases that expire no later than May 2017. Rent expense was \$3,964,000, \$4,609,000 and \$2,786,000, for the years ended December 31, 2010, 2009 and 2008, respectively. In 2010, the Company renewed the lease for its corporate

SHUTTERFLY, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (Continued)

office. The lease provides for a \$2.1 million tenant improvement reimbursement allowance. Reimbursements under this provision will be recorded as a deferred lease incentive and will reduce rent expense over the remaining lease term.

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 also has non-cancelable operating leases for certain production equipment with terms ranging from three to five years. In 2010, the Company entered into multiple non-cancellable operating leases for new digital presses with terms that expire in five years. As of December 31, 2010, the total outstanding obligation under all equipment operating leases was \$11.0 million.

At December 31, 2010, the total future minimum payments under non-cancelable operating leases are as follows (in thousands):

Year Ending:	<u>Operating Leases</u>
2011	\$ 5,820
2012	6,238
2013	6,405
2014	6,426
2015	4,817
Thereafter	<u>2,840</u>
Total minimum lease payments.....	<u>\$ 32,546</u>

Purchase obligations consist of non-cancelable marketing and service agreements and co-location services that expire at various dates through the year 2014. As of December 31, 2010, the Company's purchase obligations totaled \$16,127,000.

Indemnifications

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

Contingencies

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

Legal Matters

On October 1, 2010, Express Card Systems, LLC filed a complaint for alleged patent infringement against the Company and four other defendants in Express Card Systems, LLC. v. Shutterfly, Inc. et. al., Civ. No. 6:10-cv-514, in the Eastern District of Texas, Tyler Division. The complaint asserts infringement of U.S. Patent No. 5,751,590, which claims, among other things, a method related to processing images to define social expression cards in a computer database. The Complaint asserts that the Company directly or indirectly infringes the patents without providing any details concerning the alleged infringement, and it seeks unspecified damages

SHUTTERFLY, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (Continued)

and injunctive relief. The Company has not yet answered or otherwise responded to the complaint.

On December 10, 2010, Eastman Kodak Company filed a complaint for alleged patent infringement against the Company in *Eastman Kodak Company v. Shutterfly, Inc.*, C.A. No. 10-1079-SLR, in the U.S. District Court for the District of Delaware. The complaint asserts infringement of U.S. Patents Nos. 6,549,306; 6,600,572; 7,202,982; 6,069,712; and 6,512,570, which claim among other things, methods for selecting photographic images using index prints, an image handling system incorporating coded instructions, and processing a roll of exposed photographic film into corresponding visual prints and distributing such prints. The Complaint asserts that the Company directly or indirectly infringes the patents without providing any details concerning the alleged infringement, and it seeks unspecified damages and injunctive relief. The Company has not yet answered or otherwise responded to the complaint.

On December 13, 2010, the Company filed a complaint for patent infringement against Eastman Kodak Company and Kodak Imaging Network, Inc. (“Kodak”) in *Shutterfly, Inc. v. Eastman Kodak Company and Kodak Imaging Network, Inc.*, Case No. CV 10 5672 in the U.S. District Court for the Northern District of California. The complaint asserts infringement of U.S. Patents Nos. 6,583,799; 7,269,800; 6,587,596; 6,973,222; 7,474,801; 7,016,869; and 7,395,229, which claim among other things, methods for image uploading, image cropping, automatic generation of photo albums, and changing attributes of an image-based product. The Complaint asserts that Kodak directly or indirectly infringes the patents, and it seeks unspecified damages and injunctive relief. Kodak has not yet answered or otherwise responded to the complaint. On January 31, 2011, the Company voluntarily dismissed that lawsuit without prejudice, and on the same day the Company filed a complaint in the United States District of Delaware. The new complaint asserts the same claims of infringement against Kodak.

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

Note 7 — 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.

SHUTTERFLY, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (Continued)

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. 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.

The 2006 Plan provides for automatic replenishments on January 1 of 2011, 2012, and 2013 of 3.5%, 3.3%, and 3.1%, respectively of the number of shares of the Company's common stock issued and outstanding on the December 31 immediately prior to the date of increase.

Stock Option Activity

A summary of the status of the Company's stock option plan at December 31, 2010 and changes during the period are presented in the table below (share numbers and aggregate intrinsic value in thousands):

	<u>Number of Options Outstanding</u>	<u>Weighted Average Exercise Price</u>	<u>Weighted Average Contractual Term (Years)</u>	<u>Aggregate Intrinsic Value</u>
Balances, December 31, 2009	4,689	\$ 13.88		
Granted	257	24.29		
Exercised.....	(1,320)	11.14		
Forfeited, cancelled or expired	(269)	19.49		
Balances, December 31, 2010	<u>3,357</u>	<u>\$ 15.33</u>	<u>6.1</u>	<u>\$ 65,669</u>
Options vested and expected to vest at				
December 31, 2010.....	<u>3,196</u>	<u>\$ 15.05</u>	<u>6.0</u>	<u>\$ 63,400</u>
Options vested at December 31, 2010	<u>2,716</u>	<u>\$ 13.98</u>	<u>5.6</u>	<u>\$ 56,807</u>

As of December 31, 2009 and 2008, there were 3,572,000 and 3,237,000 options vested, respectively.

During the year ended December 31, 2010, the Company granted stock options to purchase an aggregate of 257,000 shares of common stock with a weighted average grant-date fair value of \$10.62 per share. In fiscal years ended December 2009 and 2008, the Company granted stock options to purchase an aggregate of 159,000 and 642,000 shares of common stock, respectively, with a weighted average grant-date value of \$6.61 and \$5.99 per share, respectively.

The total intrinsic value of options exercised during the twelve months ended December 31, 2010, 2009 and 2008 was \$19,721,000, \$3,963,000 and \$3,662,000, respectively. Net cash proceeds from the exercise of stock options were \$14,703,000 for the twelve months ended December 31, 2010.

SHUTTERFLY, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (Continued)

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, 2010, 2009, and 2008, were as follows:

	Year Ended December 31,		
	2010	2009	2008
Dividend yield	—	—	—
Annual risk free rate of return	1.9%	2.3%	2.5%
Expected volatility	51.1%	54.1%	51.7%
Expected term (years)	4.5	4.6	4.4

Employee stock-based compensation expense recognized during the years ended December 31, 2010 and 2009 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 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, 2010, is as follows (share numbers in thousands):

	Restricted Stock Units & Awards	Weighted Average Grant Date Fair Value
Awarded and unvested, December 31, 2009	1,891	\$ 10.48
Granted	1,017	21.36
Vested	(728)	10.58
Forfeited	(161)	12.50
Awarded and unvested, December 31, 2010	<u>2,019</u>	<u>\$ 15.76</u>
Restricted stock units expected to vest, December 31, 2010	<u>1,619</u>	

Included in the RSU grants for the twelve months ended December 31, 2010 are 161,000 RSUs that have both performance and service vesting criteria (“PBRSU”). The performance criteria are tied to the Company’s 2010 financial performance and the service criteria are consistent with vesting described in the Company’s 2006 Equity Incentive Plan. 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, 2010, the performance criteria for the fiscal year was met and the associated stock-based compensation has been recognized.

SHUTTERFLY, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (Continued)

During the years ended December 31, 2010 and 2009, the fair value of awards vested were \$7,703,000 and \$5,733,000, respectively.

As of December 31, 2010, the Company had approximately \$32.7 million of state net operating loss carryforwards available to reduce future taxable income, of which \$10.3 million is associated with windfall tax benefits that will be recorded as additional paid-in capital when realized. A tax windfall is created when the tax deduction associated with stock options exercised and vesting of restricted stock units exceeds the recognized stock-based compensation expense.

At December 31, 2010, the Company had \$23,742,000 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 8 — Income Taxes

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

	December 31,		
	2010	2009	2008
Federal:			
Current.....	\$ 5,773	\$ 5,440	\$ 727
Deferred.....	2,247	(2,162)	2,640
	<u>8,020</u>	<u>3,278</u>	<u>3,367</u>
State:			
Current.....	294	977	1,156
Deferred.....	(226)	(741)	(2,952)
	<u>68</u>	<u>236</u>	<u>(1,796)</u>
Total income tax expense (benefit):			
Current.....	6,067	6,417	1,883
Deferred.....	2,021	(2,903)	(312)
	<u>\$ 8,088</u>	<u>\$ 3,514</u>	<u>\$ 1,571</u>

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

	December 31,		
	2010	2009	2008
Income tax expense at statutory rate	34.0%	34.0%	34.0%
State income taxes	1.7%	3.5%	(3.7)%
Stock-based compensation	(0.4)%	6.2%	16.7%
R&D tax credit.....	(2.6)%	(6.3)%	(17.4)%
Other.....	(0.6)%	0.1%	0.4%
	<u>32.1%</u>	<u>37.5%</u>	<u>30.0%</u>

At December 31, 2010, the Company had approximately \$32.7 million of state net operating loss carryforwards to reduce future regular taxable income, of which \$10.3 million is associated with windfall tax benefits that will be recorded as additional paid-in capital when realized. These carryforwards will expire beginning in the year 2016 for state purposes, if not utilized. The Company recognized the remaining federal net operating loss carryforward in 2010, except for federal net operating losses associated with the Company's acquisition of TinyPictures in the amount of \$1.5 million.

SHUTTERFLY, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (Continued)

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 \$3.4 million and \$2.2 million for federal and state income tax purposes, respectively, at December 31, 2010. 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, 2010 and 2009 are as follows (in thousands):

	December 31,	
	2010	2009
Deferred tax assets:		
Net operating loss carryforwards	\$ 1,818	\$ 1,837
Reserves and other tax benefits	7,854	6,909
Tax credits	6,128	4,508
Depreciation and amortization.....	—	2,897
Other.....	725	766
Deferred tax assets	16,525	16,917
Deferred tax liabilities:		
Depreciation and amortization.....	(1,629)	—
Net deferred tax assets	\$ 14,896	\$ 16,917

As of January 1, 2010, the Company had \$2,179,000 of unrecognized tax benefits. As of December 31, 2010, the Company booked an additional \$776,000 for unrecognized tax benefits for fiscal 2010. A reconciliation of the beginning and ending amounts of unrecognized income tax benefits during the twelve month periods ended December 31, 2010, 2009 and 2008 is as follows (in thousands):

	2010	2009	2008
Balance of unrecognized tax benefits at January 1	\$ 2,179	\$ 1,766	\$ 756
Additions for tax positions of prior years	132	-	455
Additions for tax positions related to current year	644	551	555
Reductions for tax positions of prior years.....	-	(138)	-
Balance of unrecognized tax benefits at December 31	\$ 2,955	\$ 2,179	\$ 1,766

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, 2010, the Company is subject to tax in the United States, California, and 14 other jurisdictions. The Company is subject to examination for tax years including and after 1999 for federal, 2004 for California, and 2007 for other jurisdictions.

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 2010 and 2009, there were no discretionary contributions.

SHUTTERFLY, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (Continued)

Note 11 — Quarterly Financial Data (Unaudited)

Summarized quarterly financial data for the years ended December 31, 2010 and 2009 are as follows (in thousands, except per share amounts):

	Year Ended December 31, 2010			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Net Revenues	\$ 45,742	\$ 46,807	\$ 48,958	\$ 166,200
Gross Profit.....	\$ 23,164	\$ 23,628	\$ 24,052	\$ 102,372
Net income (loss)	\$ (4,731)	\$ (5,885)	\$ (4,770)	\$ 32,513
Net income (loss) per common share:				
Basic.....	\$ (0.18)	\$ (0.22)	\$ (0.17)	\$ 1.18
Diluted.....	\$ (0.18)	\$ (0.22)	\$ (0.17)	\$ 1.09
	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

Schedule II
Valuation and Qualifying Accounts

	Balance at Beginning of Period	Additions		Deductions	Balance at End of Period
		Charged to Costs and Expenses	Charged to Other Accounts		
			<i>In thousands</i>		
Allowance for Doubtful Accounts Receivable					
Year ended December 31, 2008 ...	\$ —	—	—	—	—
Year ended December 31, 2009 ...	\$ —	—	23	—	23
Year ended December 31, 2010 ...	\$ 23	23	168	(36)	155

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, 2010. The term “disclosure controls and procedures,” as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, (“Exchange Act”), means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company’s management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

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, 2010, 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 Exchange Act. 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, 2010.

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, 2010 has been audited by PricewaterhouseCoopers LLP, an independent registered public accounting firm, as stated in their report which appears herein.

Changes in Internal Control Over Financial Reporting

There were no changes in our internal control over financial reporting during the quarter ended December 31, 2010 that materially affected, or are reasonable 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, if any, 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.”

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 SCHEDULE.

(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.

SHUTTERFLY, INC.
(Registrant)

Dated: February 7, 2011

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.

<u>Signature</u>	<u>Title</u>	<u>Date</u>
<u>/s/ Jeffrey T. Housenbold</u> Jeffrey T. Housenbold	President, Chief Executive Officer and Director (Principal Executive Officer)	February 7, 2011
<u>/s/ Mark J. Rubash</u> Mark J. Rubash	Senior Vice President and Chief Financial Officer (Principal Financial and Accounting Officer)	February 7, 2011
<u>/s/ Philip A. Marineau</u> Philip A. Marineau	Chairman of the Board of Directors and Director	February 7, 2011
<u>/s/ Eric J. Keller</u> Eric J. Keller	Director	February 7, 2011
<u>/s/ Stephen J. Killeen</u> Stephen J. Killeen	Director	February 7, 2011
<u>/s/ Nancy J. Schoendorf</u> Nancy J. Schoendorf	Director	February 7, 2011
<u>/s/ Brian T. Swette</u> Brian T. Swette	Director	February 7, 2011
<u>/s/ James N. White</u> James N. White	Director	February 7, 2011

INDEX TO EXHIBITS

<u>Exhibit Number</u>	<u>Exhibit Description</u>	<u>Incorporated by Reference</u>			<u>Exhibit Number</u>	<u>Provided Herewith</u>
		<u>Form</u>	<u>File No.</u>	<u>Date of First Filing</u>		
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	Offer letter dated January 5, 2005 for Jeffrey T. Housenbold.*	S-1	333-135426	June 29, 2006	10.08	
10.04	Offer letter dated March 25, 2005 for Douglas J. Galen.*	S-1	333-135426	June 29, 2006	10.12	
10.05	Offer letter dated January 17, 2007 for Dwayne Black.*	10-K	001-33031	March 20, 2007	10.15	
10.06	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	
10.07	Offer letter dated November 27, 2007 for Mark J. Rubash.*	10-K	001-33031	March 10, 2008	10.20	
10.08	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	
10.09	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	
10.10	Amendment to Offer Letter dated December 26, 2008 for Mark J. Rubash.*	10-K	001-33031	February 24, 2009	10.19	

<u>Exhibit Number</u>	<u>Exhibit Description</u>	<u>Incorporated by Reference</u>			<u>Exhibit Number</u>	<u>Provided Herewith</u>
		<u>Form</u>	<u>File No.</u>	<u>Date of First Filing</u>		
10.11	Amendment to Offer Letter dated December 23, 2008 for Dwayne Black.*	10-K	001-33031	February 24, 2009	10.20	
10.12	Amendment to Offer Letter dated December 31, 2008 for Douglas J. Galen.*	10-K	001-33031	February 24, 2009	10.21	
10.13	Amendment to Employment Agreement dated December 8, 2008 for Jeffrey T. Housenbold.*	10-Q	001-33031	May 1, 2009	10.02	
10.14	Amendment Number 2 to Employment Agreement dated March 12, 2009 for Jeffrey T. Housenbold.*	10-Q	001-33031	May 1, 2009	10.03	
10.15	Offer Letter between Company and Peter Elarde, dated August 30, 2001.*	10-Q	001-33031	May 1, 2009	10.04	
10.16	Amendment to Offer Letter dated December 30, 2008 for Peter Elarde.*	10-Q	001-33031	May 1, 2009	10.05	
10.17	Offer Letter between Company and Neil Day, dated April 17, 2009.*	10-Q	001-33031	July 31, 2009	10.01	
10.18	Amendment No. 2 to Fulfillment Agreement and Amendment No. 1 to Supply Agreement, dated as of March 29, 2010, by and between Registrant and Fuji Photo Film U.S.A., Inc.**	10-Q	001-33031	May 3, 2010	10.01	
10.19	Lease Agreement, dated March 18, 2010, by and between the Registrant and Westport Office Park, LLC	10-Q	001-33031	May 3, 2010	10.02	
10.20	Offer Letter dated March 21, 2005 for Dan McCormick.*	10-Q	001-33031	May 3, 2010	10.03	
10.21	Amendment to Offer Letter dated December 26, 2008 for Dan McCormick.*	10-Q	001-33031	May 3, 2010	10.04	
10.22	Offer Letter dated December 17, 2007 for Peter Navin.*	10-Q	001-33031	May 3, 2010	10.05	
10.23	Amendment to Offer Letter dated December 26, 2008 for Peter Navin.*	10-Q	001-33031	May 3, 2010	10.06	

<u>Exhibit Number</u>	<u>Exhibit Description</u>	<u>Incorporated by Reference</u>			<u>Exhibit Number</u>	<u>Provided Herewith</u>
		<u>Form</u>	<u>File No.</u>	<u>Date of First Filing</u>		
10.24	2006 Equity Incentive Plan, as amended, 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.*					X
23.01	Consent of Independent Registered Public Accounting Firm.					X
24.01	Power of Attorney. (See page 64 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.

**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.

Date: February 7, 2011

By: /s/ Jeffrey T. Housenbold
Jeffrey T. Housenbold
President and Chief Executive Officer
(Principal Executive Officer)

**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.

Date: February 7, 2011

By: /s/ Mark J. Rubash
Mark J. Rubash
Senior Vice President and Chief Financial Officer
(Principal Financial Officer)

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, 2010 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.

Date: February 7, 2011

By: /s/ Jeffrey T. Housenbold
Jeffrey T. Housenbold
President and Chief Executive Officer
(Principal Executive Officer)

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, 2010 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.

Date: February 7, 2011

By: /s/ Mark J. Rubash
Mark J. Rubash
Senior Vice President and Chief Financial Officer
(Principal Financial Officer)

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, Chief Financial Officer

Dwayne A. Black
Senior Vice President, Operations

Neil M. Day
Senior Vice President, Chief Technology Officer

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

Dan C. McCormick
Senior Vice President, Products & Services

Peter C. Elarde
Senior Vice President, 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 on 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 25, 2011
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 2010. 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