BLUE NILE INC
Form 10-Q
August 13, 2009

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549
FORM 10-Q

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

For the quarterly period ended July 5, 2009

OR

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

For the transition period from __________ to __________

Commission file number 000-50763

BLUE NILE, INC.

(Exact name of registrant as specified in its charter)

Delaware	91-1963165
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification No.)*

705 Fifth Avenue South, Suite 900, Seattle, Washington	98104
(Address of principal executive offices)	*(Zip code)*

(206) 336-6700

(Registrant s telephone number, including area code)

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

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

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

As of August 7, 2009, the registrant had 14,528,024 shares of common stock outstanding.

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Cautionary Note Regarding Forward-Looking Statements

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

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

BLUE NILE, INC.
Condensed Consolidated Balance Sheets
(unaudited)
(in thousands, except par value)

	July 5, 2009	January 4, 2009
ASSETS		
Current assets:		
Cash and cash equivalents	$ 48,029	$ 54,451
Trade accounts receivable	1,102	984
Other accounts receivable	280	725
Inventories	15,733	18,834
Deferred income taxes	146	670
Prepaids and other current assets	1,381	1,069
Total current assets	66,671	76,733
Property and equipment, net	7,642	7,558
Intangible assets, net	350	271
Deferred income taxes	5,805	5,014
Other assets	68	89
Total assets	$ 80,536	$ 89,665
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 45,672	$ 62,291
Accrued liabilities	4,845	6,607
Current portion of long-term financing obligation	42	41
Current portion of deferred rent	215	205
Total current liabilities	50,774	69,144
Long-term financing obligation, less current portion	818	839
Deferred rent, less current portion	258	374
Stockholders equity:		
Preferred stock, $0.001 par value; 5,000 shares authorized, none issued and outstanding Common stock, $0.001 par value; 300,000 shares authorized; 19,693 shares and 19,659 shares issued, respectively 14,527 shares and 14,493 shares outstanding, respectively	20	20
Additional paid-in capital	149,500	144,913
Accumulated other comprehensive income	24	17
Retained earnings	40,983	36,199
Treasury stock, at cost; 5,166 shares outstanding	(161,841)	(161,841)
Total stockholders equity	28,686	19,308

Total liabilities and stockholders equity	$	80,536	$	89,665

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

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BLUE NILE, INC.
Condensed Consolidated Statements of Operations
(unaudited)
(in thousands, except per share data)

	Quarter ended		Year to date ended	
	July 5, 2009	June 29, 2008	July 5, 2009	June 29, 2008
Net sales	$ 69,852	$ 73,706	$ 132,255	$ 144,166
Cost of sales	54,822	58,583	104,022	115,119
Gross profit	15,030	15,123	28,233	29,047
Selling, general and administrative expenses	10,692	10,758	20,991	21,656
Operating income	4,338	4,365	7,242	7,391
Other income, net:				
Interest income, net	11	280	78	1,115
Other income, net	27	285	40	376
Total other income, net	38	565	118	1,491
Income before income taxes	4,376	4,930	7,360	8,882
Income tax expense	1,532	1,725	2,576	3,106
Net income	$ 2,844	$ 3,205	$ 4,784	$ 5,776
Basic net income per share	$ 0.20	$ 0.21	$ 0.33	$ 0.38
Diluted net income per share	$ 0.19	$ 0.20	$ 0.32	$ 0.36

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

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BLUE NILE, INC.
Condensed Consolidated Statement of Changes in Stockholders Equity
(unaudited)
(in thousands)

	Common Stock Shares	Common Stock Amount	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income	Treasury Stock Shares	Treasury Stock Amount	Total Stockholders Equity
Balance, January 4, 2009	19,659	$ 20	$ 144,913	$ 36,199	$ 17	(5,166)	$ (161,841)	$ 19,308
Net income				4,784				4,784
Other comprehensive income:								
Foreign currency translation adjustment					7			7
Total comprehensive income								4,791
Tax benefit from exercise of stock options			92					92
Exercise of common stock options	32		697					697
Issuance of common stock to directors	2		80					80
Stock-based compensation			3,718					3,718
Balance, July 5, 2009	19,693	$ 20	$ 149,500	$ 40,983	$ 24	(5,166)	$ (161,841)	$ 28,686

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

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BLUE NILE, INC.
Condensed Consolidated Statements of Cash Flows
(unaudited)
(in thousands)

	Year to date ended July 5, 2009	Year to date ended June 29, 2008
Operating activities:		
Net income	$ 4,784	$ 5,776
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	1,213	953
Loss on disposal of property and equipment	9	18
Stock-based compensation	3,748	3,708
Deferred income taxes	(267)	(818)
Tax benefit from exercise of stock options	92	281
Excess tax benefit from exercise of stock options	(23)	(141)
Changes in assets and liabilities:		
Receivables	327	1,667
Inventories	3,101	4,124
Prepaid expenses and other assets	(291)	59
Accounts payable	(16,619)	(44,789)
Accrued liabilities	(1,889)	(4,751)
Deferred rent and other	(106)	(33)
Net cash used in operating activities	(5,921)	(33,946)
Investing activities:		
Purchases of property and equipment	(1,208)	(880)
Proceeds from the sale of property and equipment		7
Net cash used in investing activities	(1,208)	(873)
Financing activities:		
Repurchase of common stock		(42,122)
Proceeds from stock option exercises	697	1,093
Excess tax benefit from exercise of stock options	23	141
Principal payments under long-term financing obligation	(20)	(19)
Net cash provided by (used in) financing activities	700	(40,907)
Effect of exchange rate changes on cash and cash equivalents	7	110
Net decrease in cash and cash equivalents	(6,422)	(75,616)

Cash and cash equivalents, beginning of period	54,451	122,793
Cash and cash equivalents, end of period	$ 48,029	$ 47,177

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

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Blue Nile, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(Dollar amounts in thousands except for ratios and per share data, unless noted otherwise)

Note 1. Description of Our Business and Summary of Significant Accounting Policies

The Company

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

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements should be read in conjunction with the Notes to Consolidated Financial Statements contained in the Company s Annual Report on Form 10-K for the year ended January 4, 2009, filed with the Securities and Exchange Commission on March 5, 2009. The same accounting policies are followed for preparing quarterly and annual financial statements. In the opinion of management, all adjustments necessary for the fair presentation of the financial position, results of operations and cash flows for the interim periods have been included and are of a normal, recurring nature.

The financial information as of January 4, 2009 is derived from the Company s audited consolidated financial statements and notes thereto for the fiscal year ended January 4, 2009, included in Item 8 of the Annual Report on Form 10-K for the year ended January 4, 2009.

Due to a number of factors, including the seasonal nature of the retail industry and other factors described in this report, quarterly results are not necessarily indicative of the results for the full fiscal year or any other subsequent interim period.

Principles of Consolidation

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

Use of Estimates

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

Foreign Currency

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

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

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Blue Nile, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standard (SFAS) No. 157, Fair Value Measurements (SFAS 157). SFAS 157 establishes a common definition for fair value, establishes a framework for measuring fair value, and expands disclosure about such fair value measurements.

In January 2008, the FASB issued FSP FAS 157-2, delaying the effective date of SFAS 157 by one year for nonfinancial assets and nonfinancial liabilities that are recognized or disclosed at fair value in the financial statements on a nonrecurring basis. The adoption of the SFAS 157 provisions for these nonfinancial assets and liabilities in the first quarter of 2009 did not have a material impact on the Company s consolidated results of operations or financial condition.

In April 2008, the FASB issued FSP FAS 142-3, Determination of the Useful Life of Intangible Assets (FSP FAS 142-3). FSP FAS 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under FASB Statement No. 142, Goodwill and Other Intangible Assets. The adoption of FSP FAS 142-3 in the first quarter of 2009 did not have a material impact on the Company s consolidated results of operations or financial condition.

In May 2009, the FASB issued SFAS No. 165, Subsequent Events (SFAS 165). SFAS 165 establishes principles and disclosure requirements for subsequent events, which are defined as events that occur after the balance sheet date but before financial statements are issued or are available to be issued. The adoption of SFAS 165 in the second quarter of 2009 did not have a material impact on the Company s consolidated results of operations or financial condition.

In June 2009, the FASB issued SFAS No. 168, The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles a replacement of FASB Statement No.162 (SFAS 168). SFAS 168 establishes the FASB Accounting Standards Codification as the authoritative source of generally accepted accounting principles (GAAP) in the United States. SFAS 168 is effective for financial statements issued for interim and annual periods ending after September 15, 2009. The Company does not expect the adoption of this statement to have a material impact on its consolidated results of operations or financial condition.

Note 2. Stock-based Compensation

The Company accounts for stock-based compensation arrangements in accordance with the provisions of SFAS No. 123R, Share-Based Payment (SFAS 123R). Stock options are granted at prices equal to the fair market value of the Company s common stock on the date of grant. Stock options granted generally provide for 25% vesting on the first anniversary of the date of grant, with the remainder vesting monthly in equal amounts over the following three years, and expire 10 years from the date of grant. As of July 5, 2009, the Company had four equity plans. Additional information regarding these plans is disclosed in the Company s Annual Report on Form 10-K for the year ended January 4, 2009.

In the first quarter of 2009, the Company granted restricted stock units (RSUs) to executives under the 2004 Equity Incentive Plan. The RSUs have a grant date fair value of approximately $260,000 and vest 50% on the first anniversary from the date of grant and the remainder on the second anniversary. Each RSU is converted to one share of common stock when it vests. No RSUs were granted in the second quarter of 2009.

Stock-based compensation is reduced for estimated forfeitures, and compensation expense is recognized on a straight-line basis over the requisite service period for each stock option and restricted stock unit grant.

The fair value of each stock option on the date of grant is estimated using the Black-Scholes-Merton option valuation model.

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Blue Nile, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

The following weighted-average assumptions were used for the valuation of options granted during the periods presented:

	Quarter ended		Year to date ended	
	July 5, 2009	June 29, 2008	July 5, 2009	June 29, 2008
Expected term	4 years	4 years	4 years	4 years
Expected volatility	57.0%	48.2%	54.9%	47.2%
Expected dividend yield	0.0%	0.0%	0.0%	0.0%
Risk-free interest rate	1.39%	2.95%	1.33%	2.40%
Estimated fair value per option granted	$ 18.58	$ 19.25	$ 10.00	$ 17.92

The assumptions used to calculate the fair value of options granted are evaluated and revised, if necessary, to reflect market conditions and the Company s experience.

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

A summary of stock option activity for the year to date ended July 5, 2009 is as follows:

	Options (in thousands)	Weighted Average Exercise Price	Weighted Average Remaining Contractural Term (in years)	Aggregate Intrinsic Value (in thousands)
Balance, January 4, 2009	2,290	$ 34.38		
Granted	509	23.07		
Exercised	(32)	21.79		
Cancelled	(27)	49.06		
Balance, July 5, 2009	2,740	$ 32.28	7.01	$ 32,901
Vested and expected to vest at July 5, 2009	2,585	$ 32.13	6.88	$ 31,346
Exercisable, July 5, 2009	1,600	$ 28.90	5.63	$ 23,013

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Blue Nile, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

A summary of restricted stock unit activity for the year to date ended July 5, 2009 is as follows:

	RSUs (in thousands)	Weighted Average Grant Date Fair Value	Weighted Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (in thousands)
Balance, January 4, 2009		$		
Granted	12	21.22		
Vested				
Cancelled				
Balance, July 5, 2009	12	$ 21.22	1.14	$ 490

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

The total intrinsic value of options exercised during the year to date ended July 5, 2009 was $0.7 million. During the year to date ended July 5, 2009, the total fair value of options vested was $3.9 million. As of July 5, 2009, the Company had total unrecognized compensation costs related to unvested stock options and restricted stock units of $13.8 million. The Company expects to recognize this cost over a weighted average period of 2.9 years for its options and 1.6 years for its restricted stock units.

Note 3. Inventories

Inventories are stated at cost and consist of the following:

	July 5, 2009	January 4, 2009
Loose diamonds	$ 391	$ 695
Fine jewelry, watches and other	15,342	18,139
	$ 15,733	$ 18,834

Note 4. Commitments and Contingencies

As previously disclosed in the Company s Form 10-K for the fiscal year ended January 4, 2009, Landmark Technology, LLC filed a complaint against the Company in the United States District Court for the Eastern District of Texas, alleging that the Company s website infringed on Landmark s patents. In April 2009, the Company entered into a settlement agreement with Landmark Technology, LLC (Landmark) that resulted in the purchase of a software license from Landmark by the Company. The cost of the license was recorded in the first quarter of 2009 and was not material to the financial statements.

Note 5. Net Income Per Share

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

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Blue Nile, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

The following tables set forth the computation of basic and diluted net income per share:

	Quarter ended		Year to date ended	
	July 5, 2009	June 29, 2008	July 5, 2009	June 29, 2008
Net income	$ 2,844	$ 3,205	$ 4,784	$ 5,776
Weighted average common shares outstanding	14,512	15,018	14,504	15,309
Basic net income per share	$ 0.20	$ 0.21	$ 0.33	$ 0.38
Dilutive effect of stock options and restricted stock units	703	676	467	675
Common stock and common stock equivalents	15,215	15,694	14,971	15,984
Diluted net income per share	$ 0.19	$ 0.20	$ 0.32	$ 0.36

For the quarter and year to date ended July 5, 2009, the Company excluded 749,002 and 1,070,593 stock option shares, respectively, from the computation of diluted net income per share due to their antidilutive effect. For the quarter and year to date ended June 29, 2008, the Company excluded 525,667 and 462,539 stock option shares, respectively from the computation of diluted net income per share due to their antidilutive effect.

Note 6. Subsequent Events

We have evaluated subsequent events for potential recognition or disclosure in the financial statements through August 13, 2009, which is the date these financial statements were issued.

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Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

The following discussion should be read in conjunction with our consolidated financial statements and the related notes contained elsewhere in this quarterly report on Form 10-Q and the Annual Report on Form 10-K filed for our fiscal year ended January 4, 2009.

Management Overview

We are the leading online retailer of high quality diamonds and fine jewelry. We showcase tens of thousands of independently certified diamonds and fine jewelry on our websites at www.bluenile.com, www.bluenile.ca, and www.bluenile.co.uk, and we ship our products to over 40 countries and territories across the globe.

We have a capital-efficient business model that enables us to eliminate much of the costs associated with carrying diamond inventory. Generally, we purchase diamonds on a just in time basis from our suppliers when a customer places an order for a specific diamond. We then assemble the customized diamond jewelry to our customer s specifications and deliver the finished jewelry to the customer, generally within three business days from the order date.

A principal component of our value proposition is providing an exceptional customer experience. The Blue Nile customer experience is designed to empower our customers by providing them with substantial education, guidance, selection, customization capability, convenience and value. We believe that maintaining focus on perfecting the customer experience is critical to our ongoing efforts to promote the Blue Nile brand and to continue to profitably grow our business. In March 2009, we enhanced our websites by giving customers the ability to shop and make purchases in 24 foreign currencies. We believe that offering local currencies makes it easier for our international customers to recognize the value in our product offerings and improve their shopping experience.

World diamond prices began to decline in the fourth quarter of 2008 and continued to decline throughout the first quarter of 2009. In the second quarter of 2009 prices began to stabilize, but continue to be lower on a year-over-year basis. Our just in time inventory model allows us to adjust our retail prices more quickly than traditional retailers that maintain larger physical inventories. As a result, we believe we are at a competitive advantage when diamond prices decline because our business model allows us to pass on lower prices more quickly than physical retailers. This favorable pricing environment and our consumer value proposition are leading Blue Nile to overall market share gains.

Quarter Ended July 5, 2009 Highlights

During the quarter ended July 5, 2009, our sales declined 5.2% to $69.9 million from $73.7 million in the quarter ended June 29, 2008. This result is a significant improvement from the year over year sales declines of 11.4% and 23.3% experienced in the first quarter of 2009 and fourth quarter of 2008, respectively. This sequential improvement in quarterly sales results versus the prior year was achieved even though the weakness in the United States and global economies continued. Further, consumer confidence in the United States rose slightly in the second quarter of 2009, but remained at historically low levels; and consumer credit continued to be difficult to obtain. We believe these factors have and will continue to have an impact on the demand for luxury goods, including diamonds and fine jewelry; and on our sales growth. Our gross profit as a percentage of net sales increased to 21.5% in the quarter ended July 5, 2009, compared with 20.5% for the quarter ended June 29, 2008. We achieved net income of $2.8 million and $0.19 diluted net income per share in the quarter ended July 5, 2009. As of July 5, 2009 we had cash and cash equivalents of $48.0 million and no debt.

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Results of Operations

Comparison of the Quarter Ended July 5, 2009 to the Quarter Ended June 29, 2008

The following table presents our operating results for the quarters ended July 5, 2009 and June 29, 2008, including a comparison of the financial results for these periods (dollars in thousands, except per share data):

	Quarter ended July 5, 2009	Quarter ended June 29, 2008	$ Change	% Change
Net sales	$ 69,852	$ 73,706	$ (3,854)	-5.2%
Cost of sales	54,822	58,583	(3,761)	-6.4%
Gross profit	15,030	15,123	(93)	-0.6%
Selling, general and administrative expenses	10,692	10,758	(66)	-0.6%
Operating income	4,338	4,365	(27)	-0.6%
Other income, net:				
Interest income	11	280	(269)	-96.1%
Other income, net	27	285	(258)	-90.5%
Total other income, net	38	565	(527)	-93.3%
Income before income taxes	4,376	4,930	(554)	-11.2%
Income tax expense	1,532	1,725	(193)	-11.2%
Net income	$ 2,844	$ 3,205	$ (361)	-11.3%
Basic net income per share	$ 0.20	$ 0.21	$ (0.01)	-4.8%
Diluted net income per share	$ 0.19	$ 0.20	$ (0.01)	-5.0%

Net Sales

Net sales decreased 5.2% during the quarter ended July 5, 2009, compared with the quarter ended June 29, 2008. The decrease was primarily due to a decrease in the number of orders shipped to customers, partially offset by an increase in the average shipment value. Although sales continued to be impacted by the weak economic environment and slowdown in consumer spending, sales trends improved in the second quarter of 2009 from the first quarter of 2009. The engagement category was relatively stronger than the more discretionary non-engagement jewelry category. Net sales in the U.S. decreased by 4.3% to $62.8 million during the quarter ended July 5, 2009, compared with $65.6 million during the quarter ended June 29, 2008. International sales declined by 12.3% in the quarter ended July

5, 2009, to $7.1 million, from $8.1 million in the quarter ended June 29, 2008. The strengthening of the U.S. dollar combined with macroeconomic weakness contributed to the decrease in international sales. We estimate that approximately 11.1% of the total 12.3% decrease in international sales was attributable to changes in foreign exchange rates during the second quarter of 2009, as compared to the rates in effect during the second quarter of 2008. Excluding the impact of changes in foreign exchange rates, international sales declined 1.2% in the quarter ended July 5, 2009 compared to the quarter ended June 29, 2008.

Gross Profit

Gross profit as a percentage of net sales increased to 21.5% in the quarter ended July 5, 2009, compared with 20.5% in the quarter ended June 29, 2008. The increase was attributable to the impact from diamond product mix as a result of strength at lower price points, our ability to capture the benefit of lower prices of diamonds and precious metals stemming from weak global demand for these materials, and a continued focus on cost optimization in sourcing our products.

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Diamond prices declined in late 2008 and throughout most of the first quarter of 2009. Diamond prices began to stabilize in the second quarter ended July 5, 2009 and were significantly lower compared to the price levels during the same period in 2008. During the quarter, we passed most of the lower costs on to consumers, while capturing a portion of the benefit in our gross margin. Costs for our jewelry products are impacted by prices for precious metals including gold, platinum and silver, which rise and fall based upon global supply and demand dynamics. In making retail pricing decisions, we take into account fluctuations in the pricing of precious metals, which in turn, affect the gross margin that we realize from such products. We expect that gross profit will continue to fluctuate in the future based primarily on changes in product acquisition costs, particularly diamond prices, product mix and pricing decisions. We cannot adequately predict the amount and timing of any such fluctuations.

Selling, General and Administrative Expenses

Selling, general and administrative expenses decreased 0.6% to $10.7 million in the quarter ended July 5, 2009 compared with the quarter ended June 29, 2008 due to several factors. Legal costs decreased $0.3 million in the quarter ended July 5, 2009 due to lower spending on intellectual property and other corporate matters compared to the quarter ended June 29, 2008. Marketing and advertising costs decreased approximately $0.1 million in the quarter ended July 5, 2009, primarily due to decreased spending in online marketing vehicles. These decreases were partially offset by a $0.2 million increase in payroll and related taxes, and a $0.1 million increase in depreciation expense related to additional capitalized assets. As a percentage of net sales, selling, general and administrative expenses increased to 15.3% in the quarter ended July 5, 2009, as compared to 14.6% in the quarter ended June 29, 2008. The slight increase is due to fixed costs that did not decline at the same rate as volume driven costs.

Operating Income

Operating income was $4.3 million in the quarter ended July 5, 2009 compared to $4.4 million in the quarter ended June 29, 2008. As a percentage of net sales, operating income increased to 6.2% in the second quarter of 2009 compared to 5.9% in the second quarter of 2008. The increase in operating income as a percentage of net sales for the quarter ended July 5, 2009 is due to increases in gross profit as a percentage of sales that resulted from lower product costs and improved vendor sourcing; and lower selling, general and administrative expenses resulting from diligent, focused cost management efforts.

Other Income, Net

The decrease in interest income in the quarter ended July 5, 2009 as compared with the quarter ended June 29, 2008 was predominantly due to a decrease in interest rates as well as lower overall cash balances as a result of share repurchases in the preceding 12 months. The decrease in other income was mainly due to legal settlements that occurred in the second quarter of 2008.

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Comparison of the Year to Date Ended July 5, 2009 to the Year to Date Ended June 29, 2008

The following table presents our operating results for the years to date ended July 5, 2009 and June 29, 2008, including a comparison of the financial results for these periods (dollars in thousands, except per share data):

	Year to date ended July 5, 2009	Year to date ended June 29, 2008	$ Change	% Change
Net sales	$ 132,255	$ 144,166	$ (11,911)	-8.3%
Cost of sales	104,022	115,119	(11,097)	-9.6%
Gross profit	28,233	29,047	(814)	-2.8%
Selling, general and administrative expenses	20,991	21,656	(665)	-3.1%
Operating income	7,242	7,391	(149)	-2.0%
Other income, net:				
Interest income	78	1,115	(1,037)	-93.0%
Other income, net	40	376	(336)	-89.4%
Total other income, net	118	1,491	(1,373)	-92.1%
Income before income taxes	7,360	8,882	(1,522)	-17.1%
Income tax expense	2,576	3,106	(530)	-17.1%
Net income	$ 4,784	$ 5,776	$ (992)	-17.2%
Basic net income per share	$ 0.33	$ 0.38	$ (0.05)	-13.2%
Diluted net income per share	$ 0.32	$ 0.36	$ (0.04)	-11.1%

Net Sales

Net sales decreased 8.3% during the year to date ended July 5, 2009, compared with the year to date ended June 29, 2008. The decrease was primarily due to a decrease in the number of orders shipped to customers, partially offset by an increase in the average shipment value. The engagement category was relatively stronger than the more discretionary non-engagement jewelry category. Net sales in the U.S. decreased 8.2% to $119.6 million during the year to date ended July 5, 2009, compared with $130.3 million during the year to date ended June 29, 2008. International sales declined by 8.6% in the year to date ended July 5, 2009, to $12.7 million, from $13.9 million in the year to date ended June 29, 2008. The strengthening of the U.S. dollar combined with macroeconomic weakness contributed to the decrease in international sales. We estimate that changes in foreign exchange rates during the year to date ended July 5, 2009, compared to the rates in effect during the year to date ended June 29, 2008, had a negative impact of 15.1% to international sales. Excluding the impact of changes in foreign exchange rates, international sales increased 6.5% in the year to date ended July 5, 2009 over the year to date ended June 29, 2008.

Gross Profit

The 2.8% decrease in gross profit in the year to date ended July 5, 2009 compared with the year to date ended June 29, 2008 was primarily due to the decrease in net sales. Gross profit as a percentage of net sales increased to 21.3% in the year to date ended July 5, 2009, compared with 20.1% in the year to date ended June 29, 2008. The increase was attributable to the impact from diamond product mix as a result of strength at lower price points, our ability to capture the benefit of lower prices of diamonds and precious metals stemming from weak global demand for these materials, and a continued focus on cost optimization in sourcing our products.

Selling, General and Administrative Expenses

Selling, general and administrative expenses decreased 3.1% to $21.0 million in the year to date ended July 5, 2009 compared with the year to date ended June 29, 2008 due to several factors. Marketing and advertising costs decreased approximately $1.0 million in the year to date ended July 5, 2009, primarily due to decreased spending in online marketing vehicles. Legal expenses also declined by $0.3 million in the year to date ended July 5, 2009 due to a decrease in the number of legal and corporate matters involving the Company. These decreases were partially offset by a $0.4 million increase in payroll and related taxes, and a $0.3 million increase in depreciation expense. As a percentage of net sales, selling, general and administrative expenses increased to 15.9% in the year to date ended July 5, 2009, as compared to 15.0% in the year to date ended June 29, 2008. The increase is due to fixed costs that did not decline at the same rate as our volume-driven costs.

Operating Income

Operating income was $7.2 million in the year to date ended July 5, 2009 compared to $7.4 million in the year to date ended June 29, 2008. As a percentage of net sales, operating income increased to 5.5% in the year to date ended July 5, 2009 compared to 5.1% in the year to date ended June 29, 2008. The increase in operating income as a percentage of net sales for the year to date ended July 5, 2009 is due to increases in gross profit as a percentage of sales that resulted from lower product costs and improved vendor sourcing; and lower selling, general and administrative expenses resulting from diligent, focused cost management efforts.

Other Income, Net

The decrease in interest income in the year to date ended July 5, 2009 as compared with the year to date ended June 29, 2008 was due to a decrease in interest rates as well as lower overall cash balances as a result of share repurchases in the preceding 12 months. The decrease in other income was mainly due to legal settlements that occurred in the second quarter of 2008.

Liquidity and Capital Resources

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

Recessionary economic cycles, investment and credit market conditions, unemployment levels and other economic factors impact consumer spending patterns. The extensive weakening of the U.S. and global economies that began in 2008 has had a significant impact on consumer spending, including the sale of luxury products such as diamonds and fine jewelry. Economic conditions in the U.S. are beginning to stabilize, however, we believe our revenue, cash flow from operations and net income may continue to be negatively impacted until macroeconomic conditions improve.

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

As of July 5, 2009, working capital totaled $15.9 million, including cash and cash equivalents of $48.0 million, inventory of $15.7 million and $3.0 million in other current assets, partially offset by accounts payable of $45.7 million and $5.1 million in other current liabilities. We believe that our current cash and cash equivalents will be sufficient to continue our operations and meet our capital needs for at least the next 12 months.

Net cash of $5.9 million was used in operating activities for the year to date ended July 5, 2009, compared to net cash used in operating activities of $33.9 million for the year to date ended June 29, 2008. Net payment of payables totaled $16.6 million for the year to date ended July 5, 2009 and $44.8 million for the year to date ended June 29, 2008. In the first quarter, we generally have a significant pay down of our accounts payable balance built up during the fourth quarter holiday season. The volume of sales in the quarter ended January 4, 2009 was lower than the volume of sales in the quarter ended December 30, 2007, resulting in a lower net payment of payables in the year to date ended July 5, 2009 compared to the year to date ended June 29, 2008. Additionally, due to the timing of the

July 4th holiday in 2009, the payment of approximately $4 million in payables shifted from the second quarter into the third quarter of 2009. Net payment of accrued liabilities decreased to $1.9 million in the year to date ended July 5, 2009, compared to $4.8 million in the year to date ended June 29, 2008 due to lower marketing and employee compensation expenses accrued at the end of fiscal year 2008, compared to fiscal year 2007.

Net cash of $1.2 million and $0.9 million was used in investing activities for the year to date ended July 5, 2009 and June 29, 2008, respectively, for purchases of property and equipment to support our operations.

Net cash of $0.7 million provided by financing activities for the year to date ended July 5, 2009 related primarily to proceeds from stock option exercises. Net cash used in financing activities for the year to date ended June 29, 2008 of $40.9 million related primarily to repurchases of Blue Nile, Inc. common stock, partially offset by proceeds from the exercise of stock options.

During the year to date ended July 5, 2009, we did not repurchase any shares of our common stock. On February 6, 2008, our board of directors authorized the repurchase of up to $100 million of Blue Nile, Inc. common stock during the 24-month period following the approval date of such additional repurchase. As of July 5, 2009, approximately $83.5 million remains under this repurchase authorization. Since the inception of our buyback program in the first quarter of 2005 through July 5, 2009, we have repurchased 4.4 million shares for a total of $161.2 million. The shares may be repurchased from time to time in open market transactions or in negotiated transactions off the market. The timing and amount of any shares repurchased is determined by management based on our evaluation of market conditions and other factors, including our cash needs. Repurchases may also be made under a Rule 10b5-1 plan, which would permit shares to be repurchased when we might otherwise be precluded from doing so under insider trading laws. We continually assess market conditions, our cash position, operating results, current forecasts and other factors when making decisions about stock repurchases.

We do not carry any long or short-term debt other than trade payables, deferred rent and other short term liabilities incurred in the ordinary course of business. However, projections of future cash needs and cash flows are subject to many factors and to uncertainty. We continually assess our capital structure and opportunities to obtain credit facilities, sell equity or debt securities, or undertake other transactions for strategic reasons or to further strengthen our financial position. However, there can be no assurance that additional equity, debt or other financing transactions will be available in amounts or on terms acceptable to us, if at all.

Contractual Obligations

There have been no material changes to the contractual obligations during the period covered by this report, outside of the ordinary course of business, from those disclosed in our Annual Report on Form 10-K for the year ended January 4, 2009.

Off-Balance Sheet Arrangements

As of July 5, 2009, we did not have any off-balance sheet arrangements that have or are reasonably likely to have a current or future material effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

The Company s exposure to financial market risk results primarily from fluctuations in interest rates and foreign currency exchange rates. In March 2009, we expanded the capabilities of our websites from allowing customers to purchase our products in two foreign currencies to allowing purchases in 24 foreign currencies. This expansion increases our exposure to foreign exchange rate fluctuations. Fluctuations in exchange rates throughout the second fiscal quarter of 2009, compared to rates in effect in the second fiscal quarter of 2008 negatively impacted international revenues by approximately $0.9 million in the quarter ended July 5, 2009. Fluctuations in exchange rates for the year to dated ended July 5, 2009 compared to the year to date ended June 29, 2008 negatively impacted international revenues by approximately $2.1 million.

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Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

During the quarter ended July 5, 2009, an evaluation was performed under the supervision and with the participation of our management, including our chief executive officer and chief financial officer (collectively, our certifying officers), of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act). Disclosure controls and procedures are controls and other procedures designed to ensure that information required to be disclosed by us in our periodic reports filed or submitted under the Exchange Act with the Securities and Exchange Commission (SEC) is recorded, processed, summarized and reported within the time periods specified by 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 an issuer in the reports that it files or submits under the Exchange Act is accumulated and communicated to the issuer s management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure. Based on their evaluation, our certifying officers concluded that as of the end of the period covered by this report, these disclosure controls and procedures are effective in the timely recording, processing, summarizing and reporting of material financial and non-financial information and are designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is accumulated and communicated to management, including our principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

Changes in Internal Control Over Financial Reporting

There were no changes in our internal control over financial reporting during the quarter ended July 5, 2009, that our certifying officers concluded materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings

See discussion of legal proceedings in Note 4 of the condensed consolidated financial statements.

Item 1A. Risk Factors

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

We have marked with an asterisk (*) those risks described below that reflect substantive changes from the risks described under Part I, Item 1A Risk Factors included in our Annual Report on Form 10-K for the fiscal year ended January 4, 2009, as filed with the Securities and Exchange Commission on March 5, 2009.

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

Our financial performance and results of operations depend significantly on worldwide economic conditions and their impact on consumer spending. Luxury products, such as diamonds and fine jewelry, are discretionary purchases for consumers. Recessionary economic cycles, higher interest rates, higher fuel and energy costs, inflation, levels of unemployment, conditions in the residential real estate and mortgage markets, access to credit, consumer debt levels, unsettled financial markets, and other economic factors that may affect consumer spending or buying habits could materially and adversely affect demand for our products. In addition, the recent turmoil in the financial markets has had and may continue to have an adverse effect on the United States and world economy, which could negatively impact consumer spending patterns for the foreseeable future. There can be no assurances that government responses to the disruptions in the financial markets will restore consumer confidence. Reductions in consumer spending or disposable income may affect us more significantly than companies in other industries and companies with a more diversified product offering. In addition, the current global financial crisis may materially and adversely affect our suppliers financial performance, liquidity and access to capital. This may affect their ability to maintain their inventories, production levels and/or product quality, and could cause them to raise prices, lower production levels or result in their ceasing operations.

Further, a reduction in our sales will affect our liquidity. As discussed under Liquidity and Capital Resources in Part I, Item 2 of this Form 10-Q, our liquidity is primarily dependent upon our net cash from operating activities. Our net cash from operating activities is sensitive to many factors, including changes in working capital and the timing and magnitude of capital expenditures. Working capital at any specific point in time is dependent upon many variables, including our operating results, seasonality, inventory management and assortment expansion, the timing of cash receipts and payments, and vendor payment terms.

Although the Company does not anticipate needing additional capital in the near term, financial market disruption may make it difficult for the Company to raise additional capital, when needed, on acceptable terms or at all. The interest rate environment and general economic conditions could also impact the investment income the Company is able to earn on securities it may hold from time to time.

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

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Our cash and cash equivalents are concentrated in a few financial institutions.

We maintain the majority of our cash and cash equivalents in accounts with three major financial institutions in the United States of America, in the form of demand deposits, money market accounts, U.S. Treasury Bills and other short-term investments. Deposits in these institutions may exceed the amounts of insurance provided on such deposits. If any of these institutions becomes insolvent, it could substantially harm our financial condition and we may lose some, or all, of such deposits.

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

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

- demand for our products;
- the costs to acquire quality diamonds and precious metals;
- our ability to attract visitors to our websites and convert those visitors into customers;
- general economic conditions, both domestically and internationally;
- our ability to retain existing customers or encourage repeat purchases;
- our ability to manage our product mix and inventory;
- wholesale diamond prices;
- consumer tastes and preferences for diamonds and fine jewelry;
- our ability to manage our operations;
- the extent to which we provide for and pay taxes;
- stock-based compensation expense as a result of the nature, timing and amount of stock options and restricted stock units granted, the underlying assumptions used in valuing stock options, the estimated rate of stock option and restricted stock unit forfeitures and other factors;
- advertising and other marketing costs;
- our, or our competitors , pricing and marketing strategies;
- the introduction of competitive websites, products, price decreases or improvements;
- conditions or trends in the diamond and fine jewelry industry;
- conditions or trends in the Internet and e-commerce industry;
- the success of our geographic, service and product line expansions;
- foreign exchange rates;
- interest rates; and

costs of expanding or enhancing our technology or websites.

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

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

We have experienced and expect to continue to experience seasonal fluctuations in our net sales. In particular, a disproportionate amount of our net sales has been realized during the fourth quarter as a result of the December holiday season, and we expect this seasonality to continue in the future. Approximately 29%, 35% and 36% of our net sales in the years ended January 4, 2009, December 30, 2007 and December 31, 2006, respectively, were generated during the fourth quarter of each year. In anticipation of increased sales activity during the fourth quarter, we may incur significant additional expenses, including higher inventory of jewelry and additional staffing in our fulfillment and customer support operations. If we experience lower than expected net sales during any fourth quarter, it may have a disproportionately large impact on our operating results and financial condition for that year. Further, we may experience an increase in our net shipping cost due to complimentary upgrades, split-shipments, and additional long-zone shipments necessary to ensure timely delivery for the holiday season. We also experience considerable fluctuations in net sales in periods preceding other annual occasions such as Valentine s Day and Mother s Day. In the future, our seasonal sales patterns may become more pronounced, may strain our personnel and fulfillment activities, and may cause a shortfall in net sales as compared with expenses in a given period, which would substantially harm our business and results of operations.

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

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

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

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

A majority of the world s supply of rough diamonds is controlled by a small number of diamond mining firms. As a result, any decisions made to restrict the supply of rough diamonds by these firms to our suppliers could substantially impair our ability to acquire diamonds at commercially reasonable prices, if at all. We do not currently have any direct supply relationship with these firms. Our ability to acquire diamonds and fine jewelry is also substantially dependent on our relationships with various suppliers. Approximately 21% of our payments to our diamond and fine jewelry suppliers for each of the years ended January 4, 2009, December 30, 2007 and December 31, 2006 were made to our top three suppliers. Our inability to maintain and expand these and other future diamond and fine jewelry supply relationships on commercially reasonable terms or the inability of our current and future suppliers to maintain arrangements for the supply of products sold to us on commercially reasonable terms would substantially harm our business and results of operations. The financial performance and viability of our suppliers are also significantly dependent upon worldwide economic conditions and consumer demand for diamonds and fine jewelry. The failure of any of our principal suppliers to remain financially viable could adversely impact our supply of diamonds and fine jewelry for sale to our customers.

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

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

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

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

We do not collect or have imposed upon us sales or other taxes related to the products we sell, except for certain corporate level taxes, sales taxes with respect to purchases by customers located in the State of Washington and the State of New York, and certain taxes required to be collected on sales to customers outside of the United States of America. One or more states or foreign countries may seek to impose additional sales or other tax collection obligations on us in the future. A successful assertion by one or more states or foreign countries that we should be collecting sales or other taxes on the sale of our products could result in substantial tax liabilities for past sales, discourage customers from purchasing products from us, decrease our competitive advantage with respect to traditional retailers or otherwise substantially harm our business and results of operations.

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

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

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

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

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

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

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

The retail jewelry industry is intensely competitive, and we expect competition in the sale of diamonds and fine jewelry to increase and intensify in the future. Increased competition may result in price pressure, reduced gross margins and loss of market share, any of which could substantially harm our business and results of operations. Furthermore, our competitors may react to falling consumer confidence by reducing their retail prices. Such reduction and/or inventory liquidations can have a short-term adverse effect on our sales. Current and potential competitors include:

- independent jewelry stores;
- retail jewelry store chains, such as Tiffany & Co. and Bailey Banks & Biddle;
- other online retailers that sell jewelry, such as Amazon.com;
- department stores, chain stores and mass retailers, such as Nordstrom and Neiman Marcus;
- online auction sites, such as eBay;
- catalog and television shopping retailers, such as Home Shopping Network and QVC; and
- discount superstores and wholesale clubs, such as Wal-Mart and Costco Wholesale.

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

Many of our current and potential competitors have advantages over us, including longer operating histories, greater brand recognition, existing customer and supplier relationships, and significantly greater financial, marketing and other resources. In addition, traditional store-based retailers offer consumers the ability to physically handle and examine products in a manner that is not possible over the Internet as well as a more convenient means of returning and exchanging purchased products.

Some of our competitors seeking to establish an online presence may be able to devote substantially more resources to website systems development and exert more leverage over the supply chain for diamonds and fine jewelry than we can. In addition, larger, more established and better capitalized entities may acquire, invest or partner with traditional and online competitors as use of the Internet and other online services increases. Our online competitors can duplicate many of the products, services and content we offer, which could harm our business and results of operations.

We may be unsuccessful in further expanding our operations internationally.

Through the year ended January 4, 2009, international net sales have represented less than 10% of our total annual net sales. In 2008, we increased our product offerings and marketing and sales efforts throughout Europe, Canada and the Asia-Pacific region and anticipate continuing to expand our international sales and operations in the future either by expanding local versions of our website for foreign markets or through acquisitions or alliances with third parties. Any international expansion plans we choose to undertake will increase the complexity of our business, require attention from management and other personnel and cause additional strain on our operations, technology systems, financial resources, and our internal financial control and reporting functions. Further, our expansion efforts may be unsuccessful. We have minimal experience in selling our products in international markets and in conforming to the local cultures, standards or policies necessary to successfully compete in those markets. We cannot be certain that we will be able to expand our global presence if we choose to further expand internationally. In addition, we may have to compete with retailers that have more experience with local markets. Our ability to expand and succeed internationally may also be limited by the demand for our products, the ability to successfully transact in foreign currencies, the ability of our brand to resonate with foreign consumers and the adoption of electronic commerce in these markets. Different privacy, censorship and liability standards and regulations, and different intellectual property laws in foreign countries may prohibit expansion into such markets or cause our business and results of operations to suffer.

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

- the need to develop new supplier and jeweler relationships;
- international regulatory requirements, tariffs and duties;
- difficulties in staffing and managing foreign operations;
- longer payment cycles from credit card companies;
- greater difficulty in accounts receivable collection;
- our reliance on third-party carriers for product shipments to our customers;
- risk of theft of our products during shipment;
- limited shipping and insurance options for us and our customers;
- potential adverse tax consequences;
- foreign currency exchange risk;
- lack of infrastructure to adequately conduct electronic commerce transactions or fulfillment operations;
- unclear foreign intellectual property protection laws;

laws and regulations related to corporate governance and employee/employer relationships;

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price controls or other restrictions on foreign currency;

difficulties in obtaining export, import or other business licensing requirements;

increased payment risk and greater difficulty addressing credit card fraud;

consumer and data protection laws;

lower levels of adoption or use of the Internet

geopolitical events, including war and terrorism, and

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

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

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

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

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

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

We rely on the services of our key personnel, any of whom would be difficult to replace.

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

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

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

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

Our ability to successfully receive and fulfill orders and to provide high quality customer service depends in part on the efficient and uninterrupted operation of our computer and communications systems. Substantially all of the computer hardware necessary to operate our websites is located at a single leased facility. Our systems and operations are vulnerable to damage or interruption from human error, fire, flood, power loss, telecommunications failure, terrorist attacks, acts of war, break-ins, earthquake and similar events. We do not presently have redundant systems in multiple locations and our business interruption insurance may be insufficient to compensate us for losses that may occur. In addition, our servers are vulnerable to computer viruses, denial of service attacks, physical or electronic break-ins and similar disruptions, which could lead to interruptions, delays, loss of critical data, the inability to fulfill customer orders or the unauthorized disclosure of confidential customer data. The occurrence of any of the foregoing risks could substantially harm our business and results of operations.

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

A significant barrier to online commerce and communications is the secure transmission of confidential information over public networks. Our failure to prevent security breaches could damage our reputation and brand and substantially harm our business and results of operations. Currently, a majority of our sales are billed to our customers credit card accounts directly. We rely on encryption and authentication technology licensed from third parties to effect secure transmission of confidential information, including credit card numbers. Advances in computer capabilities, human errors, new discoveries in the field of cryptography or other developments may result in a compromise or breach of the technology used by us to protect customer transaction data. In addition, any party who is able to illicitly obtain a user s password could access the customer s transaction data. An increasing number of websites and Internet companies have reported breaches of their security. Any such compromise of our security could damage our reputation, business and brand and expose us to a risk of loss or litigation and possible liability, which would substantially harm our business, and results of operations. In addition, anyone who is able to circumvent our security measures could misappropriate proprietary information or cause interruptions in our operations, damage our computers or those of our users, or otherwise damage our reputation and business. These issues are likely to become more difficult as we expand the number of countries in which we operate. We may need to expend significant resources to protect against security breaches or to address problems caused by breaches.

We rely exclusively on the sale of diamonds and fine jewelry for our net sales, and demand for these products could decline.

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

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

In recent years, increasing attention has been focused on conflict diamonds, which are diamonds extracted from war-torn regions in Africa and sold by rebel forces to fund insurrection. Diamonds are, in some cases, also believed to be used to fund terrorist activities in some regions. We support the Kimberley Process, an international initiative intended to ensure diamonds are not illegally traded to fund conflict. As part of this initiative, we require our diamond suppliers to sign a statement acknowledging compliance with the Kimberley Process, and invoices received for diamonds purchased by us must include a certification from the vendor that the diamonds are conflict free. In

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addition, we prohibit the use of our business or services for money laundering or terrorist financing in accordance with the USA Patriot Act. Through these and other efforts, we believe that the suppliers from whom we purchase our diamonds seek to exclude conflict diamonds from their inventories. However, we cannot independently determine whether any diamond we offer was extracted from these regions. Current efforts to increase consumer awareness of this issue and encourage legislative response could adversely affect consumer demand for diamonds. Consumer confidence is dependent, in part, on the certification of our diamonds by independent laboratories. A decline in the quality of the certifications provided by these laboratories could adversely impact demand for our products. Additionally, a decline in consumer confidence in the credibility of independent diamond grading certifications could adversely impact demand for our diamond products.

Our jewelry offerings must reflect the tastes and preferences of a wide range of consumers whose preferences may change regularly. Our strategy has been to offer primarily what we consider to be classic styles of fine jewelry, but there can be no assurance that these styles will continue to be popular with consumers in the future. If the styles we offer become less popular with consumers and we are not able to adjust our product offerings in a timely manner, our net sales may decline or fail to meet expected levels.

***Interruptions to our systems that impair customer access to our websites would damage our reputation and brand and substantially harm our business and results of operations*.**

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

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

Except for loose diamonds, substantially all of the fine jewelry we sell is from our physical inventory. Changes in consumer tastes for these products subject us to significant inventory risks. The demand for specific products can change between the time we order an item and the date we receive it. If we under-stock one or more of our products, we may not be able to obtain additional units in a timely manner on terms favorable to us, if at all, which would damage our reputation and substantially harm our business and results of operations. In addition, if demand for our products increases over time, we may be forced to increase inventory levels. If one or more of our products does not achieve widespread consumer acceptance, we may be required to take significant inventory markdowns, or may not be able to sell the product at all, which would substantially harm our results of operations.

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

On February 2, 2006, our board of directors authorized the repurchase of up to $100 million of our common stock during the subsequent 24-month period following the approval date of such repurchase. This repurchase program expired on February 2, 2008. On July 27, 2006, our board of directors authorized the repurchase of up to an additional $50 million of our common stock within the 24-month period following the approval date of such additional repurchase. This repurchase authorization expired on July 27, 2008. On February 6, 2008, our board of directors authorized the repurchase of up to an additional $100 million of our common stock within the 24-month period following the approval date of such additional repurchase. These repurchases and any repurchases we may make in the future may not prove to be at optimal prices and our use of cash for the stock repurchase program may not prove to be the best use of our cash resources and may adversely impact our future liquidity.

We have foreign exchange risk.*

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

In March 2009, we expanded the capabilities of our websites from allowing customers to purchase our products in two foreign currencies to allowing purchases in 24 foreign currencies. This expansion increases our exposure to foreign exchange rate fluctuations and we may record significant gains or losses as a result of such fluctuations.

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

We experienced significant operating losses in each quarter from our inception in 1999 through the second quarter of 2002. As a result, our business has a limited record of profitability and may not continue to be profitable or increase profitability. If we are unable to acquire diamonds and fine jewelry at commercially reasonable prices, if net sales decline or if our expenses otherwise exceed our expectations, we may not be able to sustain or increase profitability on a quarterly or annual basis.

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

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

We currently hold the bluenile.com, bluenile.co.uk and bluenile.ca Internet domain names and various other related domain names. Domain names generally are regulated by Internet regulatory bodies. If we lose the ability to use a domain name in a particular country, we would be forced to either incur significant additional expenses to market our products within that country, including the development of a new brand and the creation of new promotional materials and packaging, or elect not to sell products in that country. Either result could substantially harm our business and results of operations. The regulation of domain names in the United States and in foreign countries is subject to change. Regulatory bodies could establish additional top-level domains, appoint additional domain name registrars or modify the requirements for holding domain names. As a result, we may not be able to acquire or maintain the domain names that utilize the name Blue Nile in all of the countries in which we currently or intend to conduct business.

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

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

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

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

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

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

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

Purchasers of diamonds and fine jewelry may not choose to shop online, which would prevent us from increasing net sales.

The online market for diamonds and fine jewelry is significantly less developed than the online market for books, music, toys and other consumer products. If this market does not gain widespread acceptance, our business may suffer. Our success will depend, in part, on our ability to attract consumers who have historically purchased diamonds and fine jewelry through traditional retailers. Furthermore, we may have to incur significantly higher and more sustained advertising and promotional expenditures or price our products more competitively than we currently anticipate in order to attract additional online consumers to our websites and convert them into purchasing customers. Specific factors that could prevent consumers from purchasing diamonds and fine jewelry from us include:

- concerns about buying luxury products such as diamonds and fine jewelry without a physical storefront, face-to-face interaction with sales personnel and the ability to physically handle and examine products;
- delivery time associated with Internet orders;
- product offerings that do not reflect consumer tastes and preferences;
- pricing that does not meet consumer expectations;
- concerns about the security of online transactions and the privacy of personal information;
- delayed shipments or shipments of incorrect or damaged products;
- inconvenience associated with returning or exchanging Internet purchased items; and
- usability, functions and features of our websites.

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

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

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

- actual or perceived lack of security of information or privacy protection;
- possible disruptions, computer viruses, spyware, phishing, attacks or other damage to the Internet servers, service providers, network carriers and Internet companies or to users computers; and
- excessive governmental regulation.

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

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

Under current credit card practices, we are liable for fraudulent credit card transactions because we do not obtain a cardholder s signature. We do not currently carry insurance against this risk. To date, we have experienced minimal losses from credit card fraud, but we face the risk of significant losses from this type of fraud as our net sales increase and as we expand internationally. Our failure to adequately control fraudulent credit card transactions could damage our reputation and brand and substantially harm our business and results of operations. Additionally, for certain payment transactions, including credit and debit cards, we pay interchange and other fees, which may increase over time and raise our operating costs and lower our operating margins.

We rely on our relationships with third-party consumer credit companies to offer financing for the purchase of our products.

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

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

A key component of our business strategy includes strengthening our competitive position and refining the customer experience on our websites through internal development. However, from time to time, we may selectively pursue acquisitions of businesses, technologies or services. Integrating any newly acquired businesses, technologies or services may be expensive and time-consuming. To finance any acquisitions, it may be necessary for us to raise additional funds through public or private financings. Additional funds may not be available on terms that are favorable to us, and, in the case of equity financings, would result in dilution to our stockholders. If we do complete any acquisitions, we may be unable to operate such acquired businesses profitably or otherwise implement our strategy successfully. If we are unable to integrate any newly acquired entities or technologies effectively, our business and results of operations could suffer. The time and expense associated with finding suitable and compatible businesses, technologies or services could also disrupt our ongoing business and divert our management s attention. Future acquisitions by us could also result in large and immediate write-offs or assumptions of debt and contingent liabilities, any of which could substantially harm our business and results of operations. We have no current plans, agreements or commitments with respect to any such acquisitions.

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

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

We may have exposure to greater than anticipated tax liabilities.

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

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

We are not currently subject to direct federal, state or local regulation other than regulations applicable to businesses generally or directly applicable to retailing and online commerce. However, as the Internet becomes increasingly popular, it is possible that laws and regulations may be adopted with respect to the Internet, which may impede the growth of the Internet or other online services. These regulations and laws may cover issues such as taxation, advertising, intellectual property rights, freedom of expression, pricing, restrictions on imports and exports, customs, tariffs, information security, privacy, data protection, content, distribution, electronic contracts and other communications, the provision of online payment services, broadband residential Internet access, and the characteristics and quality of products and services. Further, the growth of online commerce may prompt calls for more stringent consumer protection laws. Several states have proposed legislation to limit the uses of personal user information gathered online or require online companies to establish privacy policies. The Federal Trade Commission has also initiated action against at least one online company regarding the manner in which personal information is collected from users and provided to third parties. The adoption of additional privacy or consumer protection laws could create uncertainty in Internet usage and reduce the demand for our products and services.

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

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

As a public reporting company, we are required to comply with the Sarbanes-Oxley Act of 2002 and the related rules and regulations of the SEC, including expanded disclosures and accelerated reporting requirements and more complex accounting rules. Compliance with Section 404 of the Sarbanes-Oxley Act of 2002 and other requirements

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may increase our costs and require additional management time and resources. We may need to implement additional finance and accounting systems, procedures and controls to satisfy new reporting requirements. If our internal control over financial reporting is determined to be ineffective, investors could lose confidence in the reliability of our internal control over financial reporting, which could adversely affect our stock price.

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

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

- transaction processing and fulfillment;
- inventory management;
- customer support;
- management of multiple supplier relationships;
- operational, financial and managerial controls;
- reporting procedures;
- management of our facilities;
- recruitment, training, supervision, retention and management of our employees; and
- technology operations.

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

Item 4. Submission of Matters to a Vote of Security Holders

At the Annual Meeting of Stockholders of the Company held on May 19, 2009, the stockholders elected three directors to serve until the 2012 Annual Meeting of Stockholders and ratified the Audit Committee s selection of Deloitte & Touche LLP to serve as the Company s independent registered public accounting firm for the fiscal year ending January 3, 2010. The terms of the other members of the Company s Board of Directors, Leslie Lane, Ned Mansour, Diane Irvine, Mark Vadon and Eric Carlborg, continued after the 2009 Annual Meeting of Stockholders. Proxies for the meeting were solicited pursuant to Section 14(a) of the Securities Exchange Act of 1934, as amended.

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The table below shows the results of the stockholders voting:

	Votes in Favor	Votes Against	Votes Withheld/ Abstentions	Broker Non-Votes
Proposal 1:				
Election of three directors for three-year terms expiring at the 2012 annual meeting of stockholders:				
Mary Alice Taylor	13,341,538	NA	87,704	NA
Michael Potter	13,343,252	NA	85,990	NA
Steve Scheid	12,955,780	NA	473,462	NA
Proposal 2:				
Ratification of the selection of Deloitte & Touche LLP as the Company s independent registered public accounting firm for the fiscal year ending January 3, 2010	13,417,124	10,343	1,775	NA

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Item 6. Exhibits

See exhibits listed under the Exhibit Index on page 37.

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SIGNATURES

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

BLUE NILE, INC.
Registrant

Date: August 13, 2009

/s/ Marc D. Stolzman
Marc D. Stolzman
Chief Financial Officer
(Principal Financial Officer and Duly
Authorized Officer)

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EXHIBIT INDEX

Exhibit Number	Description
3.1(1)	Amended and Restated Certificate of Incorporation of Blue Nile, Inc.
3.2(2)	Amended and Restated Bylaws of Blue Nile, Inc.
3.3(3)	Amendment to the Bylaws of Blue Nile, Inc.
4.1	Reference is made to Exhibits 3.1, 3.2 and 3.3.
4.2(4)	Specimen Stock Certificate.
4.3(2)	Amended and Restated Investor Rights Agreement dated June 29, 2001 by and between Blue Nile, Inc. and certain holders of Blue Nile, Inc. s preferred stock.
31.1(5)	Certification of Chief Executive Officer, as required by Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended.
31.2(5)	Certification of Chief Financial Officer, as required by Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended.
32.1(5)*	Certification of Chief Executive Officer, as required by Rule 13a-14(b) of the Securities Exchange Act of 1934, as amended, and 18 U.S.C. Section 1350.
32.2(5)*	Certification of Chief Financial Officer, as required by Rule 13a-14(b) of the Securities Exchange Act of 1934, as amended, and 18 U.S.C. Section 1350.

(1) Previously filed as Exhibit 3.1 to Blue Nile, Inc. s Form 10-Q for the quarterly period ended July 4, 2004 (No. 000-50763), as filed with the Securities and Exchange Commission on August 6, 2004, and incorporated by reference herein.

(2) Previously filed as the like numbered exhibit to Blue

Nile, Inc. s Registration Statement on Form S-1 (No. 333-113494), as filed with the Securities and Exchange Commission on March 11, 2004, as amended, and incorporated by reference herein.

(3) Previously filed as Exhibit 3.2 to Blue Nile, Inc. s Current Report on Form 8-K (No. 000-50763), as filed with the Securities and Exchange Commission on February 7, 2008, and incorporated by reference herein.

(4) Previously filed as Exhibit 4.2 to Blue Nile, Inc. s Registration Statement on Form S-1/A (No. 333-113494), as filed with the Securities and Exchange Commission on May 4, 2004, as amended, and incorporated by reference herein.

(5) Filed herewith.

* The certifications attached as Exhibits 32.1 and 32.2 accompany

this quarterly report on Form 10-Q pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 and shall not be deemed filed by Blue Nile, Inc. for purposes of Section 18 of the Securities Exchange Act of 1934, as amended.

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