BLUE NILE INC
Form 10-Q
August 11, 2005

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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 3, 2005

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 is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes o No þ

As of July 31, 2005, the registrant had 17,534,900 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 relate to future events and our future performance that are based on current expectations, estimates, forecasts and projections about the industries in which we operate and the beliefs and assumptions of our management. 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, potential, targets, seek, or 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 Factors that May Affect Future Operating Results and elsewhere in this Form 10-Q. These factors may cause our actual results to differ materially from any forward-looking statements. Except as required by law, we undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

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PART I. FINANCIAL INFORMATION

ITEM 1. Financial Statements

BLUE NILE, INC.
Consolidated Balance Sheets

	July 3, 2005	January 2, 2005
	(in thousands, except par value)	
Assets		
Current assets:		
Cash and cash equivalents	$ 31,489	$ 59,499
Restricted cash	119	
Marketable securities	49,821	41,868
Accounts receivable	656	760
Inventories	8,849	9,914
Deferred income taxes	7,021	8,442
Prepaids and other current assets	1,197	1,046
Total current assets	99,152	121,529
Property and equipment, net	3,431	3,916
Intangible assets, net	368	385
Deferred income taxes	1,472	2,475
Other assets	77	77
Total assets	$104,500	$128,382
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	$ 18,150	$ 37,775
Accrued liabilities	2,755	5,713
Current portion of deferred rent	207	203
Total current liabilities	21,112	43,691
Deferred rent, less current portion	953	1,071
Commitments and contingencies		
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; 18,573 shares and 18,478 shares issued, respectively; 17,561 shares and 17,728 shares outstanding, respectively;	19	18
Additional paid-in capital	105,276	104,684
Deferred compensation	(696)	(929)
Accumulated other comprehensive loss	(2)	(2)
Accumulated deficit	(14,120)	(19,515)
Treasury stock, at cost; 1,012 shares and 750 shares outstanding, respectively	(8,042)	(636)

Total stockholders equity	82,435	83,620
Total liabilities and stockholders equity	$104,500	$128,382

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

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BLUE NILE, INC.
Consolidated Statements of Operations

	Quarter Ended		Year to Date Ended	
	July 3, 2005	July 4, 2004	July 3, 2005	July 4, 2004
	(in thousands, except per share data)			
Net sales	$43,826	$ 35,022	$ 87,942	$70,806
Cost of sales	33,836	27,095	68,265	54,667
Gross profit	9,990	7,927	19,677	16,139
Selling, general and administrative expenses	6,184	5,111	12,307	10,419
Operating income	3,806	2,816	7,370	5,720
Other income (expense) net:				
Interest income	559	97	1,060	139
Other income		14		38
	559	111	1,060	177
Income before income taxes	4,365	2,927	8,430	5,897
Income tax expense	1,572	1,063	3,035	2,129
Net income	$ 2,793	$ 1,864	$ 5,395	$ 3,768
Basic net income per share	$ 0.16	$ 0.18	$ 0.30	$ 0.51
Diluted net income per share	$ 0.15	$ 0.11	$ 0.29	$ 0.22

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

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BLUE NILE, INC.
Consolidated Statements of Changes in Stockholders Equity

	Stockholders Equity								
	Common Stock Shares	Amount	Additional Paid-in Capital	Deferred Compensation	Accumulated Deficit	Accumulated Other Comprehensive Loss	Treasury Stock Shares	Amount	Total Stockholders Equity
				(in thousands)					
Balance, January 2, 2005	18,478	$18	$104,684	$ (929)	$(19,515)	$ (2)	(750)	$ (636)	$83,620
Net income					5,395				5,395
Other comprehensive income (loss):									
Unrealized loss on marketable securities, net of tax									
Total comprehensive income									5,395
Shares repurchased							(262)	(7,406)	(7,406)
Tax effect of stock option exercises			459						459
Amortization of deferred stock compensation				154					154
Reversal of deferred compensation relating to cancelled options			(79)	79					
Exercise of common stock options	94	1	197						198
Issuance of common stock	1		15						15
Balance, July 3, 2005	18,573	$19	$105,276	$ (696)	$(14,120)	$ (2)	(1,012)	$(8,042)	$82,435

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

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BLUE NILE, INC.
Consolidated Statements of Cash Flows

	Year to Date Ended	
	July 3, 2005	July 4, 2004
	(in thousands)	
Operating activities:		
Net income	$ 5,395	$ 3,768
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation and amortization	835	734
Loss on disposal of assets	10	
Stock-based compensation	169	188
Deferred income taxes	2,883	2,017
Changes in assets and liabilities:		
Receivables, net	104	326
Inventories	1,065	3,523
Prepaid expenses and other assets	(151)	(748)
Accounts payable	(19,625)	(12,502)
Accrued liabilities	(2,958)	(1,486)
Deferred rent	(114)	(99)
Net cash used in operating activities	(12,387)	(4,279)
Investing activities:		
Purchases of property and equipment	(346)	(425)
Proceeds from the sale of property and equipment	5	
Purchases of marketable securities	(71,955)	(15,928)
Proceeds from the sale of marketable securities	64,000	
Transfers of restricted cash	(119)	340
Net cash used in investing activities	(8,415)	(16,013)
Financing activities:		
Proceeds from sale of common stock, net of issuance costs		42,493
Repurchase of common stock	(7,406)	
Proceeds from warrant and stock option exercises	198	62
Net cash (used in) provided by financing activities	(7,208)	42,555
Net (increase) in cash and cash equivalents	(28,010)	22,263
Cash and cash equivalents, beginning of period	59,499	30,383
Cash and cash equivalents, end of period	$ 31,489	$ 52,646

Supplemental disclosure of cash flow information:

Non-cash financing activities:		
Conversion of mandatorily redeemable preferred stock to common stock	$	$ 57,485

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

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BLUE NILE, INC.

Notes to Consolidated Financial Statements

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

The Company

Blue Nile, Inc. (the Company) is a leading online retailer of high quality diamonds and fine jewelry. In addition to sales of diamonds, fine jewelry and watches, the Company provides 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 maintains its primary website at www.bluenile.com. The Company also operates the www.bluenile.co.uk and www.bluenile.ca websites.

Change in Fiscal Year

On January 1, 2004, the Company s fiscal year-end changed from December 31, to the Sunday closest to December 31. Each fiscal year consists of four 13-week quarters, with an extra week added onto the fourth quarter every five to six years. As a result of this transition, the year to date ended July 4, 2004 consisted of two additional shipping days as compared to the year to date ended July 3, 2005. These additional days contributed approximately $0.3 million to net sales for the year to date ended July 4, 2004.

Basis of Presentation

The accompanying unaudited 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 filed for the year ended January 2, 2005. 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 have been included and are of a normal, recurring nature.

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.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, 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 reserve for estimated fraud losses. Actual results could differ materially from those estimates.

Intangible Assets

Intangible assets represent the consideration paid for licenses and other similar agreements with finite lives. Amortization is calculated on a straight-line basis over the estimated useful life of the related assets, which range from 10 years to 17 years.

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BLUE NILE, INC.

Notes to Consolidated Financial Statements

Stock-Based Compensation

The Company accounts for stock-based employee compensation arrangements in accordance with the provisions of Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations including Financial Accounting Standards Board (FASB) Interpretation No. 44, Accounting for Certain Transactions involving Stock Compensation, an interpretation of APB Opinion No. 25. The Company has elected to apply the disclosure-only provisions of Statement of Financial Accounting Standards (SFAS) No. 123, Accounting for Stock Based Compensation. Had compensation cost for the Company s stock options been determined based on the fair value of the options at the date of grant, the Company s pro forma net income would have been as shown below (in thousands, except per share data):

	Quarter Ended		Year to Date Ended	
	July 3, 2005	July 4, 2004	July 3, 2005	July 4, 2004
Net income, as reported	$2,793	$1,864	$5,395	$3,768
Add: Stock-based compensation expense, as reported	79	82	154	188
Deduct: Stock-based employee compensation expense determined under fair-value-based method, net of tax	(511)	(140)	(966)	(307)
Pro forma net income	$2,361	$1,806	$4,583	$3,649
Income per share:				
Basic as reported	$ 0.16	$ 0.18	$ 0.30	$ 0.51
Basic pro forma	$ 0.13	$ 0.17	$ 0.26	$ 0.50
Diluted as reported	$ 0.15	$ 0.11	$ 0.29	$ 0.22
Diluted pro forma	$ 0.13	$ 0.10	$ 0.24	$ 0.21

Recent Accounting Pronouncements

In December 2004, the FASB issued SFAS No. 123R (Revised 2004), Share-Based Payment (SFAS 123R). This statement addresses the accounting for share-based payment transactions in which a company receives employee services in exchange for the company s equity instruments or liabilities that are based on the fair value of the company s equity securities or may be settled by the issuance of these securities. SFAS 123R eliminates the ability to account for share-based compensation using APB 25 and generally requires that such transactions be accounted for using a fair value method. The provisions of this statement are effective for financial statements issued in the first annual reporting period commencing after June 15, 2005. Therefore, the Company will adopt the provisions of SFAS 123R in its first quarter of 2006. The stock-based compensation the Company will recognize after the adoption of SFAS 123R will be affected by the number and type of stock-based awards granted in the future and the pricing model and related assumptions the Company decides to use to estimate the fair values of options.

The Company is currently evaluating which pricing model it will use to estimate the value of its options and which transition method it will use to implement SFAS 123R. Management has not yet determined the impact that the adoption of SFAS No. 123R will have on the Company s results of operations.

In March 2005, the SEC issued Staff Accounting Bulletin No. 107 (SAB 107), Share Based Payment, which expresses the SEC s views on the interaction between SFAS No. 123R and certain SEC rules and regulations. The Company is currently assessing the guidance in SAB 107 as part of its evaluation of the adoption of SFAS No. 123R.

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BLUE NILE, INC.

Notes to Consolidated Financial Statements

Note 2. Inventories

Inventories are stated at cost and consist of the following (in thousands):

	July 3, 2005	January 2, 2005
Loose diamonds	$1,119	$ 293
Fine jewelry, watches and other	7,730	9,621
	$8,849	$9,914

Note 3. Marketable Securities

The Company s marketable securities are classified as available-for-sale as defined by SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities (SFAS 115). At July 3, 2005, marketable securities consisted of U.S. government and agencies securities maturing within one year. The securities are carried at fair value, with the unrealized gains and losses included in accumulated other comprehensive income (loss). Realized gains or losses on the sale of marketable securities are identified on a specific identification basis and are reflected as a component of interest income or expense.

Marketable securities totaled $49.8 million and $41.9 million at July 3, 2005 and January 2, 2005, respectively. There were no realized gains or losses on the sales of marketable securities for the quarter ended July 3, 2005. Gross unrealized gains and losses at July 3, 2005 and January 2, 2005 were not material.

Any unrealized losses are considered temporary as the duration of the decline in value has been short, the extent of the decline is not severe and we have the ability to hold the investments until we recover substantially all of the cost of the investment.

Note 4. 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 warrants and mandatorily redeemable convertible preferred stock, except when the effect of their inclusion would be antidilutive.

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BLUE NILE, INC.

Notes to Consolidated Financial Statements

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

	Quarter Ended		Year to Date Ended	
	July 3, 2005	**July 4, 2004**	**July 3, 2005**	**July 4, 2004**
Net income	$ 2,793	$ 1,864	$ 5,395	$ 3,768
Weighted average common shares outstanding	17,625	10,388	17,688	7,329
Basic net income per share	$ 0.16	$ 0.18	$ 0.30	$ 0.51
Dilutive effect of stock options and warrants	1,025	1,228	1,038	1,179
Dilutive effect of mandatorily redeemable convertible preferred stock		6,000		8,513
Common stock and common stock equivalents	18,650	17,616	18,726	17,021
Diluted net income per share	$ 0.15	$ 0.11	$ 0.29	$ 0.22

For the quarter and year to date ended July 3, 2005, there were 528,796 and 567,826, respectively, stock option shares excluded from the computation of net income per diluted share due to their antidilutive effect. For the quarter and year to date ended July 4, 2004, there were no stock option shares excluded from the computation of net income per diluted share due to their antidilutive effect.

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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 Blue Nile, Inc. s (Blue Nile, the Company, we, our, Consolidated Financial Statements and the related Notes contained elsewhere in this quarterly report on Form 10-Q and annual report on Form 10-K filed for our fiscal year ended January 2, 2005. There have been no material changes in our critical accounting policies and estimates and assumptions since January 2, 2005.

Overview

Net income in the second quarter of 2005 was $2.8 million, or $0.15 per diluted share. In the second quarter of 2004, net income and net income per diluted share were $1.9 million and $0.11, respectively. The 49.9% increase in net income for the quarter was primarily driven by the growth in net sales.

In August 2004, the Company launched a website in the United Kingdom, www.bluenile.co.uk through which the Company offers a limited number of products and in January 2005, the Company launched a website in Canada, www.bluenile.ca.

Results of Operations

Comparison of the Quarter Ended July 3, 2005 to the Quarter Ended July 4, 2004

Net Sales

Net sales increased 25.1% to $43.8 million in the quarter ended July 3, 2005 compared to $35.0 million in the quarter ended July 4, 2004. The increase in net sales was primarily due to an increase in net sales of engagement rings, diamond jewelry and loose diamonds.

Gross Profit

Gross profit increased 26.0% to $10.0 million for the quarter ended July 3, 2005 from $7.9 million in the quarter ended July 4, 2004. The increase in gross profit resulted primarily from increases in sales volume. Gross profit as a percentage of net sales increased to 22.8% for the quarter ended July 3, 2005 from 22.6% in the quarter ended July 4, 2004. The increase in gross profit as a percentage of net sales resulted from changes in our product mix and changes in our retail pricing.

Selling, General and Administrative Expenses

Selling, general and administrative expenses increased 20.9% to $6.2 million for the quarter ended July 3, 2005 from $5.1 million in the quarter ended July 4, 2004. The increase in selling, general and administrative expenses in the second quarter of 2005 was due to several factors. Additional costs associated with being a public company were approximately $655,000 in the second quarter of 2005 as compared to approximately $220,000 in the second quarter of 2004. These costs relate primarily to corporate governance, directors and officers insurance, legal and accounting fees and investor relations. Salaries and related benefits costs increased approximately $267,000 resulting primarily from the addition of new employees, and credit card processing fees increased approximately $139,000 due to higher sales volumes.

As a percentage of net sales, selling, general and administrative expenses were 14.1% in the quarter ended July 3, 2005 compared to 14.6% in the quarter ended July 4, 2004. The decrease in these expenses as a percentage of net sales resulted primarily from our ability to grow sales at a greater pace than selling, general and administrative expenses.

Interest Income

Interest income was approximately $559,000 for the quarter ended July 3, 2005, compared to approximately $97,000 in the quarter ended July 4, 2004. The increase in interest income is primarily due to an increase in our cash and cash equivalents and marketable securities as a result of our initial public stock offering completed in May 2004, which resulted in net proceeds to the Company of $42.5 million, and as a result of cash generated by operations.

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Comparison of the Year to Date Ended July 3, 2005 to the Year to Date Ended July 4, 2004

Net Sales

Net sales increased 24.2% to $87.9 million in the year to date ended July 3, 2005 compared to $70.8 million in the year to date ended July 4, 2004. The increase in net sales was primarily due to an increase in net sales of engagement rings, diamond jewelry and loose diamonds.

The Company transitioned to a four-four-five retail fiscal calendar year on January 1, 2004. As a result of this transition, the year to date ended July 4, 2004 consisted of two additional shipping days as compared to the year to date ended July 3, 2005. These additional days contributed approximately $0.3 million to net sales for the year to date ended July 4, 2004.

Gross Profit

Gross profit increased 21.9% to $19.7 million for the year to date ended July 3, 2005 from $16.1 million in the year to date ended July 4, 2004. The increase in gross profit resulted primarily from increases in sales volume. Gross profit as a percentage of net sales declined to 22.4% for the year to date ended July 3, 2005 from 22.8% in the year to date ended July 4, 2004. The decrease in gross profit as a percentage of net sales resulted primarily from changes in product mix.

Selling, General and Administrative Expenses

Selling, general and administrative expenses increased 18.1% to $12.3 million for the year to date ended July 3, 2005 from $10.4 million in the year to date ended July 4, 2004. The increase in selling, general and administrative expenses in the year to date ended July 3, 2005 was due primarily to additional costs associated with being a public company. These costs were approximately $1.4 million for the year to date ended July 3, 2005 as compared to approximately $470,000 for the year to date ended July 4, 2004. These costs relate primarily to corporate governance, directors and officers insurance, legal and accounting fees and investor relations. Additionally, salaries and related benefits costs increased approximately $281,000 resulting primarily from the addition of new employees, and credit card processing fees increased approximately $176,000 due to higher sales volumes.

As a percentage of net sales, selling, general and administrative expenses were 14.0% in the year to date ended July 3, 2005 compared to 14.7% in the year to date ended July 4, 2004. The decrease in these expenses as a percentage of net sales resulted primarily from our ability to grow sales at a greater pace than selling, general and administrative expenses.

Interest Income

Interest income was approximately $1.1 million for the year to date ended July 3, 2005, compared to approximately $139,000 in the year to date ended July 4, 2004. The increase in interest income is primarily due to an increase in our cash and cash equivalents and marketable securities as a result of our initial public stock offering completed in May 2004, which resulted in net proceeds to the Company of $42.5 million, and as a result of cash generated by our operations.

Liquidity and Capital Resources

As of July 3, 2005, we had working capital of $78.0 million, including cash and cash equivalents of $31.5 million and marketable securities of $49.8 million, partially offset by accounts payable of $18.2 million. We believe that our current cash and cash equivalents and marketable securities as well as cash flows from operations will be sufficient to continue our operations and meet our capital needs for the foreseeable future.

Net cash of $12.4 million was used for operating activities in the year to date ended July 3, 2005, compared to cash used in operating activities of $4.3 million in the year to date ended July 4, 2004. Cash was provided by earnings of $5.4 million and $3.8 million in the year to date ended July 3, 2005 and July 4, 2004, respectively. This was offset by net payments of payables totaling $19.6 million for the year to date ended July 3, 2005 and $12.5 million for the year to date ended July 4, 2004. The increase in net payments of payables in 2005 relates primarily to higher payments to suppliers in the first quarter for inventory sold in the fourth quarter. The volume of sales in the fourth quarter of 2004 was greater than the volume in the fourth quarter of 2003, resulting in an increase in the net payment of payables in the first quarter of 2005 compared to the first quarter of 2004. This payment cycle reflects what we believe to be the beneficial working capital characteristics of our business model, wherein we collect cash from customers within several business days following a related sale while we typically have longer payment terms with our suppliers.

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Net cash used in investing activities was $8.4 million for the year to date ended July 3, 2005 and $16.0 million for the year to date ended July 4, 2004. Cash used in 2005 was primarily for net purchases of marketable securities of $8.0 million. Cash used in 2004 was also the result of purchases of marketable securities.

Net cash used in financing activities for the year to date ended July 3, 2005 was $7.2 million resulting primarily from repurchases of Blue Nile, Inc. common stock. In February 2005, our board of directors authorized the repurchase of common stock with aggregate total value of $30.0 million within the 12 months following the date of approval of such repurchase. The timing and amount of any shares repurchased will be determined by our management based on its evaluation of market conditions and other factors. During the year to date ended July 3, 2005, we purchased 262,200 shares of our common stock for approximately $7.4 million. Cash provided by financing activities for the year to date ended July 4, 2004 was $42.6 million and was primarily the result of our initial public stock offering completed in May 2004, which resulted in net proceeds of $42.5 million.

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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. In those cases, the trading price of our common stock could decline and you may lose all or part of your investment.

Our limited operating history makes it difficult for us to accurately forecast net sales and appropriately plan our expenses.

We were formed in March 1999 and have a limited operating history. As a result, it is difficult to accurately forecast our net sales and plan our operating expenses. We 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. 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 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 diamonds and precious metals;
- our ability to attract visitors to our websites and convert those visitors into customers;
- 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;
- general economic conditions;
- advertising and other marketing costs;
- our, or our competitors , pricing and marketing strategies;
- conditions or trends in the diamond and fine jewelry industry;
- conditions or trends in the Internet and e-commerce industry; 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.

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. Over 38%, 38% and 42% of our net sales in

2004, 2003 and 2002, respectively, were generated during the fourth quarter. 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 were to experience lower than expected net sales during any future fourth quarter, it would have a disproportionately large impact on our operating results and financial condition for that year. We also experience considerable fluctuations in net sales in periods preceding other special 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 to expenses in a given period, which would substantially harm our business and results of operations.

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Our failure to acquire diamonds and fine jewelry at commercially reasonable prices would result in higher costs and lower net sales and damage our competitive position.

If we are unable to acquire 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 prices to customers that are below those of traditional jewelry retailers. 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 nor do we expect to enter into any such relationship in the foreseeable future. Our ability to acquire diamonds and fine jewelry is also substantially dependent on our relationships with various suppliers. Approximately 25%, 36% and 45% of our payments to our diamond and fine jewelry suppliers in 2004, 2003 and 2002, respectively, 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.

Suppliers and manufacturers of diamonds as well as retailers of diamonds and diamond jewelry are vertically integrated and we expect 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 for the products that they sell. 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 2002 and 2003, we instituted retail price reductions as part of our strategy to stimulate growth in net sales and optimize gross profit. We may institute similar price reductions in the future. Such price reductions may not result in an increase in net sales or 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.

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 website 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; and

inconvenience associated with returning or exchanging purchased items.

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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 online 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 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 our website development and functionality, 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 carriers and networking vendors. We also rely on third parties for information, including product characteristics and availability that we present to consumers on our website, which may, on occasion, be inaccurate. Our failure to provide our customers with 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.

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.

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 Costco Wholesale and Wal-Mart.

In addition to these competitors, we may face competition from suppliers of our products that decide to sell directly to consumers, either through physical retail outlets or through an online store.

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.

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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 website. 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 a result, these parties may be reluctant to enter into or maintain relationships with us. Without these relationships, traffic to our websites could be reduced, which would substantially harm our business and results of operations.

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

Luxury products, such as diamonds and fine jewelry, are discretionary purchases for consumers. The volume and dollar value of such purchases may significantly decrease during economic downturns. The success of our business depends in part on macroeconomic factors such as employment levels, salary levels, tax rates and credit availability, all of which affect consumer spending and disposable income. Any reduction in consumer spending or disposable income may affect us more significantly than companies in other industries.

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 large 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. Although we believe that the suppliers from whom we purchase our diamonds seek to exclude such diamonds from their inventories, we cannot independently verify 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.

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 inventory in a timely manner, our net sales may decline or fail to meet expected levels.

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.

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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. This facility is 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. We do not presently have a formal disaster recovery plan and our business interruption insurance may be insufficient to compensate us for losses that may occur in the event operations at our fulfillment center are interrupted. We recently expanded and may further expand our existing fulfillment center or transfer our fulfillment operations to a larger fulfillment center in the future. Any interruptions in our fulfillment center operations for any significant period of time, including interruptions resulting from the expansion of our existing facility or the transfer of operations to a new facility, could damage our reputation and brand and substantially harm our business and results of operations.

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

In general, we 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 and inclement weather, 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 products to us or our customers in a timely manner or to otherwise adequately serve our customers would damage our reputation and brand and substantially harm our business and results of operations.

If we 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.

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

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

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

A significant barrier to online commerce and communications is the secure transmission of confidential information over public networks. Our failure to prevent these 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. Any such compromise of our security could damage our reputation and brand and expose us to a risk of loss or litigation and possible liability, which would substantially harm our business, and results of operations. In addition, anyone who is able to circumvent our security measures could misappropriate proprietary information or cause interruptions in our operations. We may need to expend significant resources to protect against security breaches or to address problems caused by breaches.

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; and

training, supervision, retention and management of our employees.

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.

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 website 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 or a formal disaster recovery plan, 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, physical or electronic break-ins and similar disruptions, which could lead to interruptions, delays, loss of critical data, the inability to accept and 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.

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.

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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. Our future success depends on our retention of key employees, including Mark Vadon, our Chief Executive Officer, on whom we rely for management of our company, development of our business strategy and management of our strategic relationships. None of our key technical, fulfillment or senior management personnel are bound by employment or noncompetition agreements, and, as a result, any of these employees could leave with little or no prior notice. In addition, other than for Mr. Vadon, we do not have key person life insurance policies covering any of our employees.

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

We rely on a combination of patent, trademark, trade secret and copyright law and contractual restrictions to protect our intellectual property. These afford only limited protection. Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy aspects of our website features and functionality or to obtain and use information that we consider as proprietary, such as the technology used to operate our website, 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 customer 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 customer 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 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. Finally, we sell and intend to increasingly sell our products internationally, and the laws of many countries do not protect our proprietary rights to as great an extent as do the laws of the United States.

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

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

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

We 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. Actual merchandise returns are difficult to predict and may significantly exceed our allowances. Any significant increase in merchandise returns above our allowances would substantially harm our business and results of operations.

We may be unsuccessful in expanding our operations internationally.

To date, we have made very limited international sales, but we anticipate continuing to expand our international sales and operations in the future either by expanding our 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 require management attention and resources and 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 do not currently have any overseas fulfillment or distribution or server facilities, and we have very limited web content localized for foreign markets and 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 internationally may also be limited by the demand for our products 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 cause our business and results of operations to suffer.

Any 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;
- unexpected changes in international regulatory requirements and tariffs;
- difficulties in staffing and managing foreign operations;
- longer payment cycles from credit card companies;
- greater difficulty in accounts receivable collection;
- potential adverse tax consequences;
- foreign currency exchange risk;
- lack of infrastructure to adequately conduct electronic commerce transactions or fulfillment operations;
- price controls or other restrictions on foreign currency;
- difficulties in obtaining export and import licenses; and
- greater difficulty addressing credit card fraud.

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

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. Highly publicized 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 or other damage to the Internet servers or to users computers; and
- excessive governmental regulation.

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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 data, is also significantly dependent upon the availability and adoption of broadband Internet access and other high speed Internet connectivity technologies.

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

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

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

A key component of our business strategy includes strengthening our competitive position and refining the customer experience on our website through internal development. However, from time to time, we may selectively pursue acquisitions of businesses, 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 net sales may be negatively affected if we are required to charge 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 certain taxes required to be collected on sales to customers outside of the United States of America. However, one or more states or foreign countries may seek to impose 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 ability to compete with traditional retailers or otherwise substantially harm our business and results of operations.

Currently, decisions of the U.S. Supreme Court restrict the imposition of obligations to collect state and local sales and use taxes with respect to sales made over the Internet. However, implementation of the restrictions imposed by these Supreme Court decisions is subject to interpretation by state and local taxing authorities. While we believe that these Supreme Court decisions currently restrict 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 of these decisions. Moreover, a number of states, as well as the U.S. Congress, have been considering various initiatives that could limit or supersede the Supreme Court s position regarding sales and use taxes on Internet sales. If any state or local taxing jurisdiction were to disagree with our interpretation of the Supreme Court s current position regarding state and local taxation of Internet sales, or if any of these initiatives were to address the Supreme Court s constitutional concerns and result in a reversal of its current position, we could be required to collect sales and use taxes from purchasers located in states other than Washington. The imposition by state and local governments of various taxes upon Internet commerce could create administrative burdens for us and could decrease our future net sales.

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

We are subject to general business regulations and laws as well as regulations and laws specifically governing the Internet and e-commerce. Existing and future laws and regulations may impede the growth of the Internet or other online services. These regulations and laws may cover taxation, restrictions on imports and exports, customs, tariffs, user privacy, data protection, pricing, content, copyrights, distribution, electronic contracts and other communications, consumer protection, the provision of online payment services, broadband residential Internet access and the characteristics and quality of products and services. It is not clear how existing laws governing issues such as property ownership, sales and other taxes, libel and personal privacy apply to the Internet and e-commerce. Unfavorable resolution of these issues may substantially harm our business and results of operations.

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

The satisfactory performance, reliability and availability of our website, 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 interruption that results in the unavailability of our website 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, software errors or an overwhelming number of visitors trying to reach our website 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.

Our failure to address risks associated with 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.

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 website, 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.

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Changes in accounting standards and/or our accounting policy relating to stock-based compensation may negatively affect our reported results of operations.

We are not currently required to record stock-based compensation charges on employee stock options with exercise prices that equal or exceed the deemed fair value of our common stock at the date of grant. We account for stock-based employee compensation arrangements in accordance with the provisions of Accounting Principles Board Opinion (APB) No. 25, *Accounting for Stock Issued to Employees* (APB 25), and related interpretations. Under APB Opinion No. 25, compensation expense is recognized for the difference between the fair value of our stock on the date of grant and the exercise price. We have elected to apply the disclosure-only provisions of Statement of Financial Accounting Standards (SFAS) No. 123, *Accounting for Stock Based Compensation* (SFAS 123). Had compensation cost for the Company s stock options been determined based on the fair value of the options at the date of grant under SFAS 123, our net income would have been as set forth in Note 1 to our consolidated financial statements included elsewhere in this report. In December 2004, the Financial Accounting Standards Board (FASB), issued SFAS No. 123R, Share-Based Payment (Revised 2004) (SFAS 123R). Under SFAS 123R, we will record expense for the fair value of stock options granted to employees, which will result in increased charges for stock-based compensation costs. In April 2005, the SEC announced the delay of the effective date of SFAS 123R. As such, we will adopt the provisions of SFAS No. 123R in our first quarter of 2006.

We will 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 will increase our costs and require additional management time and resources. We may need to continue to implement additional finance and accounting systems, procedures and controls to satisfy new reporting requirements. Compliance with Section 404 will first apply to our annual report for the fiscal year ending January 1, 2006. If our internal controls over financial reporting are determined to be ineffective, investors could lose confidence in the reliability of our internal controls over financial reporting, which could adversely affect our stock price.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

The Company s exposure to financial market risk results primarily from fluctuations in interest rates. There have been no material changes to our market risks as disclosed in our Annual Report on Form 10-K for the year ended January 2, 2005.

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Item 4. Controls and Procedures

As of the end of the period covered by this report, 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. 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 with the Securities and Exchange Commission (SEC) is recorded, processed, summarized and reported within the time periods specified by the SEC s rules and SEC reports. Based on their evaluation, our certifying officers concluded that these disclosure controls and procedures were effective as of the end of the period covered by this report.

We believe that a controls system, no matter how well designed and operated, is based in part upon certain assumptions about the likelihood of future events, and therefore can only provide reasonable, not absolute, assurance that the objectives of the controls system are met, and no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within a company have been detected.

There were no changes in our internal control over financial reporting during the quarter ended July 3, 2005, that our certifying officers concluded materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

At the end of the fiscal year 2005, Section 404 of the Sarbanes-Oxley Act will require management to provide an assessment of the effectiveness of the Company s internal control over financial reporting, and our independent registered public accounting firm will be required to audit management s assessment. We are in the process of performing the system and process documentation, evaluation and testing required for management to make this assessment and for our independent auditors to provide their attestation report. We have not completed this process or assessment, and this process will require significant amounts of management time and resources. In the course of evaluation and testing, management may identify deficiencies that will need to be addressed and remediated.

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PART II. OTHER INFORMATION

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

(c) Repurchases

Issuer Purchases of Equity Securities

(Dollars in thousands except per share amounts)

	Total Number of Shares (or Units) Purchased	Average Price Paid per Share(or Unit)	Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs	Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs **(1)**
April 4, 2005 through May 1, 2005	100,000	$ 26.69	100,000	$ 26,217
May 2, 2005 through May 29, 2005	54,800	$ 27.48	54,800	$ 24,711
May 30, 2005 through July 3, 2005	68,400	$ 30.95	68,400	$ 22,594

(1) On February 3, 2005, the board of directors authorized the repurchase of up to $30 million of the Company s common stock prior to February 3, 2006. Such repurchase was announced on February 8, 2005. 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 will be determined by the Company s management based on its evaluation of market conditions and other factors. Repurchases may also be made under a Rule 10b5-1 plan, which would permit shares to be repurchased when the Company might otherwise be precluded from doing so under insider trading laws.

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

At the Annual Meeting of Stockholders of the Company held on May 23, 2005, the stockholders elected three directors to serve until the 2008 Annual Meeting of Stockholders and ratified the Audit Committee s selection of PricewaterhouseCoopers LLP to serve as the Company s independent registered public accounting firm for fiscal 2005. The terms of the other members of the Company s Board of Directors, Mary Alice Taylor, Augustus Tai, Diane Irvine, Joseph Jimenez and Brian McAndrews, continued after the Annual Meeting of Stockholders. Proxies for the meeting were solicited pursuant to Section 14(a) of the Securities Exchange Act of 1934, as amended.

The table below shows the results of the stockholders voting:

	Votes in Favor	Votes Against	Votes Withheld/ Abstentions
Proposal 1:			
Election of three directors for three-year terms expiring at the 2008 annual meeting of stockholders:			
Mark Vadon	15,649,803	NA	34,686
Joanna Strober	15,677,977	NA	6,512
W. Eric Carlborg	15,573,764	NA	110,725
Proposal 2:			
The selection of PricewaterhouseCoopers LLP as our independent registered public accounting firm for the fiscal year ending January 1, 2006	15,620,863	59,777	3,849

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Item 6. Exhibits

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.
4.1	Reference is made to Exhibits 3.1 and 3.2.
4.2(3)	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(4)	Certification of Chief Executive Officer Required Under Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as amended.
31.2(4)	Certification of Principal Financial Officer Required Under Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as amended.
32.1(4)*	Certification of Chief Executive Officer Required Under Rule 13a-14(b) or Rule 15d-14(b) of the Securities Exchange Act of 1934, as amended, and 18 U.S.C. Section 1350.
32.2(4)*	Certification of Principal Financial Officer Required Under Rule 13a-14(b) or Rule 15d-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 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.

(4) Filed herewith.

* The certifications attached as Exhibits 32.1 and 32.2 accompanies 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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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 10, 2005

/s/ Diane M. Irvine

Diane M. Irvine
Chief Financial Officer
(Principal Financial Officer and Duly Authorized Officer)

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