

BLUE NILE INC  
Form 10-K  
March 01, 2016

UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549  
FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
For the fiscal year ended January 3, 2016

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)  
OF THE SECURITIES EXCHANGE ACT OF 1934  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 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.)

411 First Avenue South, Suite 700

Seattle, Washington 98104

(206) 336-6700

(Address and telephone number, including area code, of principal executive offices)

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

Title of Each Class

Name of each exchange on which registered

Common Stock, \$.001 Par Value

The NASDAQ Stock Market LLC

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

None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes  No

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

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

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Large accelerated filer

Accelerated filer

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Non-accelerated filer

Smaller reporting company

(do not check if a smaller reporting company)

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

The aggregate market value of the voting stock held by non-affiliates of the registrant at July 5, 2015 was approximately \$344 million, based on the last trading price of \$30.04 per share, excluding approximately 73,000 shares held by directors and executive officers of the registrant. This calculation does not exclude shares held by organizations whose ownership exceeds 5% of the registrant's outstanding common stock as of July 5, 2015 that have represented on Schedule 13G filed with the Securities and Exchange Commission that they are registered investment advisers or investment companies registered under Section 8 of the Investment Company Act of 1940.

The number of shares outstanding of the registrant's common stock as of February 19, 2016 was 11,604,082.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the Company's definitive Proxy Statement to be filed with the Commission pursuant to Regulation 14A in connection with the 2016 Annual Meeting of Stockholders are incorporated by reference into Part III of this Annual Report on Form 10-K. The proxy statement will be filed with the Securities and Exchange Commission within 120 days of the registrant's fiscal year ended January 3, 2016.

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Table of Contents

BLUE NILE, INC.

ANNUAL REPORT ON FORM 10-K FOR THE FISCAL YEAR ENDED JANUARY 3, 2016

	Page
PART I	
Item 1. <u>Business</u>	<u>3</u>
Item 1A. <u>Risk Factors</u>	<u>7</u>
Item 1B. <u>Unresolved Staff Comments</u>	<u>20</u>
Item 2. <u>Properties</u>	<u>20</u>
Item 3. <u>Legal Proceedings</u>	<u>20</u>
Item 4. <u>Mine Safety Disclosures</u>	<u>20</u>
PART II	
Item 5. <u>Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u>	<u>20</u>
Item 6. <u>Selected Consolidated Financial Data</u>	<u>22</u>
Item 7. <u>Management’s Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>26</u>
Item 7A. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	<u>34</u>
Item 8. <u>Financial Statements and Supplementary Data</u>	<u>35</u>
Item 9. <u>Changes in and Disagreements with Accountants on Accounting and Financial Disclosure</u>	<u>59</u>
Item 9A. <u>Controls and Procedures</u>	<u>59</u>
Item 9B. <u>Other Information</u>	<u>61</u>
PART III	
Item 10. <u>Directors, Executive Officers and Corporate Governance</u>	<u>61</u>
Item 11. <u>Executive Compensation</u>	<u>61</u>
Item 12. <u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u>	<u>61</u>
Item 13. <u>Certain Relationships and Related Transactions, and Director Independence</u>	<u>61</u>
Item 14. <u>Principal Accounting Fees and Services</u>	<u>61</u>
PART IV	
Item 15. <u>Exhibits, Financial Statement Schedules</u>	<u>62</u>
<u>SIGNATURES</u>	<u>63</u>
<u>EXHIBIT INDEX</u>	<u>65</u>

Table of Contents

PART I

This Annual Report on Form 10-K 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 our 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,” “potential,” “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 Annual Report on Form 10-K. These factors, and other 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.

Item 1. Business

General

Blue Nile's fiscal year ends on the Sunday nearest to December 31. Fiscal year 2015 ended on January 3, 2016 and included 52 weeks. The fiscal year ended January 4, 2015 included 53 weeks, with the 53<sup>rd</sup> week falling in our fourth quarter. Fiscal years ended December 29, 2013, December 30, 2012, and January 1, 2012 each included 52 weeks.

Overview

Incorporated in 1999 as a Delaware corporation, Blue Nile is a leading online retailer of high-quality diamonds and fine jewelry. We offer our products for sale through the Blue Nile website in over 40 countries and territories throughout the world. Our primary focus is on growing our business and providing shareholder value by driving profitability through unparalleled quality, selection and value to consumers and delivering exceptional customer service. We believe that our extensive and unique product selection, connection with our customers through our marketing and customer service efforts, and the value we provide to our customers through our competitive pricing will result in increasing our sales and market share both domestically and internationally. Our principal corporate office is located in Seattle, Washington. Our online business model allows us to avoid many of the costs that are typically incurred by traditional physical retail stores. As a result, we are able to realize lower gross profit margins while remaining profitable and providing value to our customers through lower retail prices.

We have the following significant wholly-owned subsidiaries:

- Blue Nile, LLC (“LLC”), which serves our customers in the U.S., Canada and Asia-Pacific;
- Blue Nile Worldwide, Inc., which serves our customers in Europe;
- Blue Nile (Shanghai) Trading Co., Ltd., which serves our customers in China, and
- Blue Nile Jewellery, Ltd (“Jewellery”), which operates a customer service and fulfillment center in Dublin, Ireland.

Our domestic sales consist of products delivered to customers within the U.S. and our international sales consist of products delivered to customers outside the U.S.. Financial information by geographic area is included in Note 11 to the consolidated financial statements in Item 8 of this Annual Report on Form 10-K.

We have built a well-respected consumer brand by employing an informative sales process that empowers our customers while offering a broad selection of high-quality jewelry at very competitive prices. Our website showcases more than 150,000 independently certified diamonds and styles of fine jewelry, including rings, wedding bands, earrings, necklaces, pendants, bracelets, gifts, and accessories. We specialize in the customization of diamond jewelry with our “Build Your Own” feature that offers customers the ability to customize diamond rings, pendants and earrings. We have developed an efficient online cost structure and a unique supply solution that eliminates traditional layers of diamond wholesalers and brokers, which generally allows us to purchase most of our product offerings at lower prices by avoiding mark-ups imposed by those intermediaries. While we may selectively acquire diamond inventory that we believe will be attractive to our customers, our supply solution enables us to purchase only those diamonds that our customers have ordered. As a result, we are able to minimize the costs associated with carrying diamond inventory and limit our risk of potential mark-downs.

## Table of Contents

The importance of purchasing diamonds and fine jewelry leads consumers to seek out substantial information and trusted guidance throughout their purchasing process. Our comprehensive website and expertly trained customer service representatives (“diamond and jewelry consultants”) improve the traditional purchasing experience by providing education and detailed product information that enables our customers to objectively compare diamonds and fine jewelry products, and make informed decisions. Our website features an interactive search functionality that allows our customers to quickly find the products that meet their needs from our broad selection of diamonds and fine jewelry.

### Business Strategies

Our objective is to maximize our revenue and profitability and increase market share both domestically and internationally by offering exceptional value and service to our customers through a high-quality customer experience that leverages supply chain efficiencies, an efficient cost structure and offering excellent customer service. We have established and will continue to refine our scalable, capital-efficient business model that enables growth with lower working capital requirements than traditional store-based jewelry retailers. We also optimize the cash flow dynamics of our business by managing inventory balances along with vendor payment terms.

Our long-term strategic initiatives are aimed at delivering long-term shareholder value by increasing revenues, profits, cash flow and achieving greater scale leveraging our relatively low fixed-cost expenses and investing on initiatives to drive consumers to shift their purchase decisions to online jewelry retailers at a more significant rate. We believe that we will influence the shift to purchasing jewelry online by providing more compelling reasons to buy from us through enhancements in the online user experience, development of our engagement and non-engagement product lines, and expansion of our international operations. We are also investing in marketing to drive greater brand awareness and familiarity, utilizing our growing acumen in data analytics to refine our pricing strategy and to grow our margins, and leveraging scale to source products in ways that provide exceptional quality and value to our customers. We also are testing a limited roll-out of small retail storefronts, which we call our Webroom Concept, to determine if innovative physical presence in targeted markets encourage more customers to buy online from us.

### Product Offerings and Supplier Relationships

Our merchandise consists of engagement and non-engagement products. The engagement product category includes gold or platinum engagement rings with a diamond center stone and loose diamonds. Our non-engagement product category includes rings, wedding bands, earrings, necklaces, pendants, bracelets, gifts and accessories containing precious metals, diamonds, gemstones, or pearls. Our core business is the engagement category.

Our online business model, combined with the strength of our supplier relationships, enables us to pursue a dynamic merchandising strategy. Our exclusive diamond supplier relationships allow us to display suppliers’ diamond inventories on the Blue Nile website for sale to consumers without holding the diamonds in our inventory until the products are ordered by customers. We purchase polished diamonds from over 50 suppliers, many of whom have long-standing relationships with us. We typically enter into multi-year agreements with diamond suppliers that provide for high-quality diamonds to be offered exclusively online to consumers through the Blue Nile website. Our diamond suppliers purchase rough and polished diamonds from sources throughout the world. Their ability to supply us with diamonds is dependent upon their ability to procure these diamonds.

While we currently offer over 150,000 diamonds that are independently certified by third party diamond grading laboratories, typically the Gemological Institute of America, we aim to limit our diamond offerings to those possessing characteristics associated with high-quality. Accordingly, we offer diamonds with specified characteristics

in the areas of shape, cut, color, clarity, and carat weight.

We generally 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 diamond with a ring, pendant or earring setting from our inventory into customized diamond jewelry according to our customer’s specifications. The finished jewelry is delivered to the customer generally within three to seven business days from the order date and within one business day for diamonds held on consignment in our fulfillment facilities.

We offer a broad range of non-engagement products to complement our selection of high-quality customized diamond jewelry. In the case of non-engagement, unlike most diamonds that we sell, we typically take products into inventory before they are ordered by our customers. Our non-engagement products are purchased from over 90 manufacturers, most of whom have long-standing relationships with us. We generally enter into purchase order agreements with suppliers of non-engagement

## Table of Contents

products. These purchase order agreements establish terms for quantity, price, payment and shipping. Additionally, we enter into operating agreements with these suppliers that include product quality requirements, product specifications and shipping procedures. We believe that our current suppliers are able to sufficiently meet our product needs and that there are alternative sources for most products that we purchase.

### Marketing

Our marketing and advertising efforts include online and offline initiatives, which primarily consist of search engines, online videos, online display advertising, affiliate programs, direct online marketing, e-mail marketing, social networking/advertising and public relations.

### Customer Service and Support

A key element of our business is our ability to provide a high level of customer service and support. We augment our online information resources with knowledgeable, highly-trained support staff through our call centers to give customers confidence in their purchases. Our diamond and jewelry consultants are trained to provide guidance on all steps in the process of buying engagement and non-engagement products, including, among other things, the process for selecting an appropriate item, the purchase of that item, financing and payment alternatives, and shipping services. Our commitment to customers is reflected in both high service levels that are provided by our extensively-trained diamond and jewelry consultants, as well as in our guarantees and policies. We prominently display all of our guarantees and policies on our website to create an environment of trust. These include policies relating to privacy, security, product availability, pricing, shipping, refunds, exchanges, diamond upgrades, lifetime warranty, and special orders. We typically offer a return policy of 30 days. We generally do not extend credit to customers; however our customers can make purchases through third-party credit cards and our private label credit card through a sponsoring bank (the "Blue Nile Credit Card"). The Blue Nile Credit Card provides various financing options to our customers and is a vehicle for promoting loyalty programs and other unique offers to our cardholders.

### Fulfillment Operations

Our fulfillment operations are designed to enhance value for our customers by fulfilling orders quickly, securely and accurately. When an order for customized diamond jewelry is received, the third-party supplier who holds the diamond in inventory generally ships it to us, or to independent third-party jewelers with whom we maintain ongoing relationships for assembly, within one to three business days. Upon receipt, the merchandise is sent to assembly for setting and sizing, which is performed by our jewelers or independent third-party jewelers. Each diamond is inspected upon arrival from our suppliers, and each finished product is inspected prior to shipment to a customer. Prompt and secure delivery of our products is a high priority, and we ship nearly all diamond and fine jewelry products via nationally recognized carriers. Loose diamonds and customized diamond jewelry products may be shipped by us or by our suppliers or third-party jewelers directly to our customers.

### Technology and Systems

Our technology systems use a combination of proprietary, licensed and open-source technologies. We focus our internal development efforts on creating and enhancing the features and functionality of our website across multiple platforms as well as further refining our order processing and fulfillment systems to deliver a high-quality customer experience. We license third-party information technology systems for our financial reporting, inventory management, call center operations, order fulfillment, and merchandising. We use hosted service providers for e-mail, content distribution and other services. We use redundant Internet carriers to minimize the risk of downtime. Our systems are monitored continuously using third-party software, and an on-call team is staffed to respond to any emergencies or



unauthorized access in the technology infrastructure.

#### Seasonality

We generally experience seasonal fluctuations in demand for our products. Our quarterly revenue is generally the highest in the fourth quarter due to Christmas. The fourth quarter accounted for approximately 31%, 33%, and 32% of our net sales in the fiscal years ended January 3, 2016, January 4, 2015 and December 29, 2013, respectively.

#### Competition

The engagement and non-engagement retail market is intensely competitive and highly fragmented. Our primary competition comes from online and offline retailers that offer products within the higher quality segment of the jewelry market. We also compete with other retailers that move into the higher quality jewelry segment. Current and potential competitors include the following:

5

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## Table of Contents

- independent jewelry stores,
- retail jewelry store chains,
- online retailers that sell jewelry and online jewelry retailers,
- department stores, chain stores and mass retailers,
- online auction sites,
- catalog and television shopping retailers,
- discount superstores and wholesale clubs, and
- Internet shopping clubs.

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. We also face competition from entities that make and market synthetic stones and gems to compete in the market for diamonds and diamond jewelry.

We believe that the principal competitive factors in our market are product selection and quality, customer service and support, price, brand recognition, reputation, reliability and trust, website features and functionality, convenience, and delivery performance. We believe that we compete favorably in the market for engagement and non-engagement products by focusing on these factors.

## Intellectual Property

We rely on general intellectual property law and contractual restrictions and, to a limited extent, copyrights and patents, to protect our proprietary rights and technology. These contractual restrictions include confidentiality agreements, invention assignment agreements and nondisclosure agreements with employees, contractors, suppliers and strategic partners. In addition, we pursue the registration of our trademarks and service marks in the U.S. and certain other countries. In the U.S. and certain other countries, we have registered or have applications pending for, “Blue Nile,” the BN logo, the Blue Nile BN stylized logo, “Build Your Own Ring,” “Build Your Own Five-Stone Ring,” “Build Your Own Three Stone Ring,” “Build Your Own Diamond Jewelry,” “Build Your Own Diamond Pendant,” “Build Your Own Earrings,” and “Build Your Own Charm Bracelet”. In addition, we are the holder of a patent entitled “Computerized Search Technique, such as an Internet-Based Gemstone Search Technique” (U.S. Patent No. 8,271,521) and have several other U.S. patent applications pending which relate to certain features of our website. We have registered the bluenile.com, bluenile.co.uk and bluenile.ca Internet domain names and various other related domain names. We have also registered copyrights with respect to certain images and information set forth on our website and certain computer codes incorporated in our website. Despite the protection of general intellectual property law and our contractual restrictions, it may be possible for a third-party to copy or otherwise obtain and use our intellectual property without our authorization. However, effective intellectual property protection or enforcement may not be available or cost effective in every country in which our products and services are made available. We also rely on technologies that we license from third parties, particularly software solutions for financial reporting, inventory management, call center operations, order fulfillment and merchandising.

## Employees

At January 3, 2016, we employed 335 full-time employees and 17 part-time employees. We also utilize temporary personnel on a seasonal basis. Our employees are not party to any collective bargaining agreement and we have never experienced an organized work stoppage. We believe our relations with our employees are good.

## Available Information

We make available, free of charge, through our website, [www.bluenile.com](http://www.bluenile.com), our Annual Report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and any amendments to those reports as soon as reasonably practicable after electronically filing such material with or furnishing it to the Securities and Exchange Commission ("SEC"). Our SEC reports, as well as our corporate governance policies and code of ethics, can be accessed through the investor relations section of our website. The information found on our website is not part of this or any other report filed with or furnished to the SEC. All of our filings with the SEC may be obtained at the SEC's Public Reference Room at 100 F Street, NE, Washington, DC 20549. For information regarding the operation of the SEC's Public Reference Room, please contact the SEC at 1-800-SEC-0330. Additionally, the SEC maintains an Internet site that contains reports, proxy and information statements and other

Table of Contents

information regarding issuers that file electronically with the SEC at [www.sec.gov](http://www.sec.gov). Amendments to, and waivers from, our code of ethics that apply to our principal executive officer and principal financial officer, or persons performing similar functions, and that relates to any element of the code of ethics definition enumerated in Item 406(b) of Regulation S-K will be disclosed at the website address provided above and, to the extent required by applicable regulations, on a current report on Form 8-K.

Item 1A. Risk Factors

You should carefully consider the risks described below and elsewhere in this Annual Report on Form 10-K, 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.

Our business results are significantly affected by the value we are able to provide to our customers.

Demand for our products has been highly sensitive to pricing changes, because 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. Pricing changes may result from changes in commodity prices or changes in our pricing strategy. The price of commodities upon which we are substantially dependent are subject to fluctuations arising from changes in supply and demand, competition, and market speculation. Because of our virtual inventory model for loose diamonds, our diamond product prices are much more sensitive to rapid fluctuations in the prices of diamonds than traditional retailers, which typically hold diamonds in inventory. Rapid and significant fluctuations in commodity prices, particularly diamond prices, may materially and adversely affect our sales, gross margins, customer experience, and competitive position. Further, we have and will continue to change our product pricing strategies. Our pricing strategies have and will likely continue to have a significant impact on our net sales, gross margins and net income.

General economic factors may 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, volatile 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, volatility in the financial markets has had and may continue to have a negative impact on consumer spending patterns. A reduction 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, negative national or global economic conditions 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 cease their operations.

Economic factors such as increased commodity prices, shipping costs, inflation, higher costs of labor, insurance and healthcare, and changes in and/or interpretations of other laws, regulations and taxes may also increase our cost of sales and our selling, general and administrative expenses, and otherwise adversely affect our financial condition and results of operations. Any significant increases in costs may affect our business disproportionately than our

competitors.

Further, any reduction in our sales will affect our liquidity. As discussed under “Liquidity and Capital Resources” in Part II, Item 7 of this Annual Report on Form 10-K, 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. Working capital at any specific point in time is dependent upon many variables, including our operating results, seasonality, inventory management and level of product assortment expansion, the timing of cash receipts and payments, and vendor payment terms.

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. Our investments in marketing may not effectively reach potential consumers or those consumers may not decide to buy from us or the volume of consumers that purchase from us may not yield the intended return on investment. With respect to our marketing channels, we rely on relationships with providers of online services, search engines, directories and other websites and e-commerce businesses to

7

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Table of Contents

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. In particular, we rely on Google as an important marketing channel, if Google changes its algorithms or if competition increases for advertisements on Google, we may be unable to cost-effectively drive qualified consumers to our website.

Our agreements with our marketing 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 whom we have online-advertising arrangements could provide advertising services to other companies, 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. Further, we use promotions as a way to drive sales, these promotional activities may not drive sales and may adversely affect our gross margins.

Our supplier relationships are a key component of our business.

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 relationships with these firms. Our ability to acquire diamonds and fine jewelry is also substantially dependent on our relationships with various suppliers. Approximately 19%, 18% and 20% of our payments to our diamond and fine jewelry suppliers for each of the years ended January 3, 2016, January 4, 2015, and December 29, 2013, respectively, were made to our top three suppliers for that year. The top three suppliers may change from year to year. 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. Further, we typically have exclusive online supply relationships with our diamond suppliers. If we were no longer able to maintain these exclusive relationships with key suppliers, this may adversely impact our diamond supply and may 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 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, 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.

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

A component of our future growth 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 sustain and promote 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

products, we have incurred and will continue to incur substantial expenses related to advertising and other marketing efforts. These expenses may not result in increased consumer demand for our products, which would negatively impact our financial results.

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 website, 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 laboratories 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

Table of Contents

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 website, which may, on occasion, be inaccurate. Likewise, we have implemented, and we require our suppliers to implement, rigorous quality assurance measures to ensure that all diamonds we sell are 100% natural. Despite these efforts and assurances from our suppliers to provide us only 100% natural diamonds, it is possible that man-made or enhanced diamonds could be mixed in with natural diamonds and passed to us without our detection. We have made commitments to our customers to sell 100% natural diamonds and any inclusion of man-made or enhanced diamonds could cause significant damage to our reputation and brand. Our failure to provide our customers with high-quality products 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.

Purchasers of diamonds and fine jewelry may not choose to shop online, which would prevent us from growing our business.

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 additional consumers who have historically purchased diamonds and fine jewelry through traditional retailers and have chosen not to purchase online. 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 online 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 items purchased online; and
- usability, functionality and features of our website.

Our financial results may be negatively affected if we are required to collect additional taxes on sales or disclose our customers' private information to tax authorities.

The application of indirect taxes (such as sales and use tax, value-added tax ("VAT"), goods and services tax, and similar taxes) to ecommerce businesses such as Blue Nile, and to our users, is a complex and evolving issue. Currently, we collect indirect taxes related to purchases by customers located in the State of Washington and the State of New York, and certain indirect taxes required to be collected on sales to customers outside of the United States. One or more states or foreign countries have sought and others may seek to impose additional indirect tax collection obligations on us in the future and/or require us to disclose to tax authorities our customers' private information, including but not limited to names, addresses, purchase amounts, and purchase dates. For example:

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the State of New York has passed legislation that requires any out-of-state seller of tangible personal property to collect and remit New York use tax if the seller engages affiliates above certain financial thresholds in New York to perform certain business promotion activities. California and several other states have enacted or introduced similar legislation.

the U.S. Congress continues to pursue legislation that would allow states to require out-of-state sellers to collect and remit indirect taxes on orders shipped to their state. If enacted, legislation could require us to collect sales tax for orders shipped to all states with such a tax.

Table of Contents

Given that we sell high value items, indirect tax is a significant consideration, and thus additional obligations to collect indirect taxes from customers may adversely impact our future sales. Changes to laws, changes to interpretations of existing laws, or changes to administrative practices by U.S. federal, U.S. state, or foreign governments to require the collection of indirect taxes on the sale of our products and/or to require us to disclose our customers' private information to tax authorities could result in substantial tax, penalty and interest liabilities for past sales; discourage customers from purchasing products from us; decrease our competitive advantage; cause us to spend additional money, time and other resources to understand and comply with multi-jurisdictional tax structures; cause us to discontinue certain successful sales and marketing initiatives; and otherwise substantially harm our business and results of operations.

Our stock price has been volatile historically, and may continue to be volatile.

The trading price of our common stock has been and may continue to be subject to wide fluctuations. Our stock price may fluctuate in response to a number of events and factors, such as quarterly variations in operating results, announcements by us or our competitors, including announcements relating to strategic decisions or key personnel, service disruptions, changes in financial estimates and recommendations by security analysts, the operating and stock price performance of other companies that investors may deem comparable to us, volatility in the financial markets and news reports relating to trends in our markets or general economic conditions. The impact of these events and factors on our stock price is amplified by the relatively low number of our shares on the market.

In addition, several of our stockholders own significant portions of our common stock. If these stockholders were to sell all or a portion of their holdings of our common stock, the market price of our common stock could be negatively impacted. The effect of such sales, or of significant portions of our stock being offered or made available for sale, could result in strong downward pressure on our stock price. Investors should be aware that they could experience significant short-term volatility in our stock if such stockholders decide to sell all or a portion of their holdings of our common stock at once or within a short period of time.

Our stock price volatility may also impact the market valuation of our Company that is out of line from the fundamental performance of the business.

Our failure or the failure of our third-party business partners to protect our sites, networks and systems against security breaches, or otherwise to protect our confidential information, could damage our reputation and brand and substantially harm our business and operating results.

We collect, maintain, transmit and store data about our customers, suppliers and others, including credit card information and personally identifiable information, as well as other confidential and proprietary information.

We also engage third-party business partners that store, process and transmit proprietary, personal and confidential information on our behalf. We rely on encryption and authentication technology licensed from third parties in an effort to securely transmit confidential and sensitive information, including credit card numbers. Advances in computer capabilities, new technological discoveries or other developments may result in the whole or partial failure of this technology to protect transaction data or other confidential and sensitive information from being breached or compromised. Our security measures, and those of our third-party business partners, may not detect or prevent all attempts to hack our systems, denial-of-service attacks, viruses, malicious software, break-ins, phishing attacks, social engineering, security breaches or other attacks and similar disruptions that may jeopardize the security of information stored in or transmitted by our sites, networks and systems or that we or our third-party business partners otherwise maintain, including payment card systems which may subject us to fines or higher transaction fees or limit or terminate our access to certain payment methods. We and our third-party business partners may not anticipate or

prevent all types of attacks until after they have already been launched. Further, techniques used to obtain unauthorized access to or sabotage systems change frequently and may not be known until launched against us or our third-party business partners. In addition, security breaches can also occur as a result of non-technical issues, including intentional or inadvertent breaches by our employees or by our third-party business partners.

Table of Contents

Breaches of our security measures or those of our third-party business partners or cyber security incidents could result in unauthorized access to our sites, networks and systems; unauthorized access to and misappropriation of consumer information, including consumers' personally identifiable information, or other confidential or proprietary information of ourselves or third parties; viruses, worms, spyware or other malware being served from our sites, networks or systems; deletion or modification of content or the display of unauthorized content on our sites; interruption, disruption or malfunction of operations; costs relating to breach remediation, deployment of additional personnel and protection technologies, response to governmental investigations and media inquiries and coverage; engagement of third party experts and consultants; litigation, regulatory action and other potential liabilities. While to our knowledge, we have not experienced a breach of consumer information, we have experienced denial-of-service, social engineering, phishing, and similar attacks; however, such attacks have not had a material adverse effect on our operations. If any of these breaches of security should occur, our reputation and brand could be damaged, our business may suffer, we could be required to expend significant capital and other resources to alleviate problems caused by such breaches and we could be exposed to a risk of loss, litigation or regulatory action and possible liability. Actual or anticipated attacks may cause us to incur increasing costs, including costs to deploy additional personnel and protection technologies, train employees and engage third-party experts and consultants. In addition, any party who is able to illicitly obtain a subscriber's password could access the subscriber's transaction data or personal information. Any compromise or breach of our security measures, or those of our third-party service providers, could violate applicable privacy, data security and other laws, and cause significant legal and financial exposure, adverse publicity and a loss of confidence in our security measures, which could have a material adverse effect on our business, financial condition and operating results. We may need to devote significant resources to protect against security breaches or to address problems caused by breaches, diverting resources from the growth and expansion of our business.

Dividend issuances, repurchases of our common stock or other investments we may make may not prove to be the best use of our cash resources.

We have and will consider issuing dividends to shareholders and we plan to continue to opportunistically repurchase shares of our common stock. These dividends may not be the best use of our cash. 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.

In addition, we have used in the past, and may use in the future, our cash and cash equivalents to make investments in certain businesses and ventures as our management thinks appropriate. These investments may decline in value after they are made or we may entirely lose the cash associated with the investment.

We may undertake wide-ranging strategic initiatives which may fail to achieve our objectives and may dilute the ownership of our existing stockholders.

A key component of our business strategy includes strengthening our competitive position to improve our long term financial performance. As part of this strategy, we may pursue strategic transactions and acquisitions of businesses, technologies or services.

In the future, we may choose to raise capital through public or private financing or other arrangements. Such financing may not be available on acceptable terms, or at all, and our failure to raise capital when needed could harm our business. We may sell our common stock, convertible securities and other equity securities in one or more transactions at prices and in a manner as we may determine from time to time. If we sell any such securities in subsequent transactions, stockholders may be materially diluted. New investors in such subsequent transactions could gain rights,

preferences and privileges senior to those of holders of our common stockholders. Debt financing, if available, may involve restrictive covenants and could reduce our operational flexibility or profitability. For example, we currently have a credit facility which contains certain financial covenants. If we cannot raise funds on acceptable terms, we may not be able to grow our business or respond to competitive pressures.

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. If we do complete any acquisitions, we may be unable to operate such acquired businesses profitably or otherwise implement our strategy successfully. Integrating any newly acquired businesses, technologies or services may be expensive and time-consuming. If we are unable to integrate any newly-acquired entities or technologies effectively, our business and results of operations could suffer. 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.

Table of Contents

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

The retail jewelry industry is intensely competitive. Online retail, including mobile and tablet, is rapidly evolving and subject to changing technology, shifting consumer preferences and tastes, and frequent introductions of new products and services. We expect the competition in the sale of diamonds and fine jewelry to increase and intensify in the future. Our current and potential competitors range from large and established companies to emerging start-ups. Larger more established companies have longer operating histories, greater brand recognition, existing customer and supplier relationships, and significantly greater financial, marketing and other resources. Additionally, larger 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. Larger competitors may also be better capitalized to opportunistically acquire, invest or partner with other domestic and international businesses.

Emerging start-ups may be able to innovate and provide products and services faster than we can, and they may be willing to price their products more aggressively in order to gain market share. 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. If our competitors are more successful than us in offering compelling products or in attracting and retaining consumers, our revenues and growth rates could decline. Such reductions 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.;
- online retailers that sell jewelry and online jewelry retailers, such as Amazon.com, James Allen and Brilliant Earth;
- 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 HSN and QVC;
- discount superstores and wholesale clubs, such as Wal-Mart and Costco Wholesale; and
- Internet shopping clubs, such as Gilt Groupe and Rue La La.

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.

We may be unsuccessful in further expanding our operations internationally.

For the fiscal year ended January 3, 2016, international net sales represented 17.1% of our total net sales. We continue to increase marketing and sales efforts and anticipate continuing to expand our international sales and operations in the future either by expanding local versions of our website for foreign markets, through acquisitions, investments or alliances with third parties, or through other means. Investments in foreign entities may be impaired and lose value, and this risk of loss is heightened by potential changes in the legal and regulatory environment in the international markets where these acquired businesses or joint ventures operate.

Further, 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 limited experience 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 consumers globally and the adoption of online or Internet 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.

Table of Contents

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 payment, 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;
- price controls or other restrictions on foreign currency;
- difficulties in obtaining export, import or other business licensing requirements;
- customs and import processes, costs or restrictions;
- 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; or
- the need to conduct business in foreign languages on both the website and in our customer service efforts.

The People's Republic of China ("PRC") governs Blue Nile's subsidiaries' and partners' businesses and operations through laws, regulations and licensing requirements restricting (i) foreign investment in Internet sales, importation of goods and services, IT infrastructure, retail and other sectors, and (ii) Internet content. There are uncertainties in the interpretation of the PRC laws, regulations and licensing requirements. If our Chinese business interests were found to be in violation of any existing or future PRC laws or regulations or if interpretations of laws and regulations were to change, the business could be subject to fines and other financial penalties, have licenses revoked, or be forced to shut down entirely.

We face foreign exchange risk.

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

Additionally, we allow customers to purchase our products in 23 currencies. This exposes us to foreign exchange rate fluctuations and we may record significant gains or losses as a result of such fluctuations. We price our diamonds based on costs denominated in U.S. dollars. Therefore, when the U.S. dollar strengthens, the retail prices of our products in international markets will become more expensive and sales may decline.





Table of Contents

System interruptions 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, our ability to attract and retain customers and to maintain adequate customer service levels. Any future system interruptions, downtime or technical difficulties that result 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, failures of Internet service and telecommunication providers, software or human errors, cyber attacks, 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 corporate headquarters, primary fulfillment center, and the co-location facility which houses our computer and communication systems are located in Seattle, Washington. A natural disaster in Seattle, Washington may result in significant physical damage to or closure of one or more of these facilities, and significantly interrupt our customer service and fulfillment center operations, which could adversely affect our results of operations. Additionally, our systems and operations are vulnerable to damage or interruption from human error, fire, flood, power loss, telecommunications failure, terrorist attacks, acts of war, acts of God, break-ins and similar events. In addition, we may experience system interruptions resulting from the construction in and around the building which houses our corporate headquarters. 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. 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 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 a limited number of third-party carriers to deliver inventory to us and product shipments to our customers. We and our suppliers are therefore subject to the risks, including employee strikes, inclement weather, power outages, national disasters, rising fuel costs and 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 and ship 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.

We rely on the services of our small, specialized workforce and key personnel, many 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 or if our personnel do not work efficiently and effectively together, our business could suffer. Although we have generally entered into employment offer letters with our key personnel, these

agreements have no specific duration and provide for at-will employment, which means they may terminate their employment relationship with us at any time. We believe that our future success will depend on our continued ability to attract, hire and retain key employees. We do not have “key person” life insurance policies covering our employees.

Competition for highly skilled personnel is often intense, especially in Seattle, Washington where our corporate headquarters and primary fulfillment center are located, and we may incur significant costs to attract them. We may not be successful in attracting, integrating, or retaining qualified personnel to fulfill our current or future needs. We have, from time to time, experienced, and we expect to continue to experience, difficulty in hiring and retaining highly skilled employees with appropriate qualifications. If we fail to attract new personnel or fail to retain and motivate our current personnel, our business and future growth prospects could be severely harmed.

## Table of Contents

If we are unable to successfully implement our webroom strategy, our growth and profitability could be adversely impacted.

We recently announced that we are planning to open new webrooms. Our ability to open new webrooms in a timely manner and operate them profitably depends on a number of factors, many of which are beyond our control, including:

- our ability to manage the financial and operational aspects of our webroom strategy, including making appropriate investments in our software systems, information technology and operational infrastructure;
- our ability to identify suitable locations, including our ability to gather and assess demographic and marketing data to accurately determine consumer demand for our products in the locations we select;
- our ability to negotiate favorable lease agreements;
- our ability to properly assess the profitability of potential new webroom locations;
- our ability to secure required governmental permits and approvals;
- our ability to hire and train highly qualified webroom personnel, especially management personnel;
- the absence of significant construction delays or cost overruns;
- our ability to implement a cost-effective construction plan;
- our competitors building or leasing stores near our webrooms or in locations we have identified as targets for a new webroom;
- webroom sales benefits may not outweigh the costs of collecting sales tax; and
- general economic and business conditions affecting consumer confidence and spending and the overall strength of our business.

We may not be able to grow the number of our webrooms, accelerate the rate of new webroom openings, achieve the net sales growth or maintain consistent levels of profitability in our webrooms, particularly as we expand into markets now served by our brick and mortar competitors. In addition, the substantial management time and resources which our webroom strategy requires may result in disruption to our existing business operations which may decrease our profitability.

Our business may be adversely affected, if we are unable to provide a cost-effective shopping platform that is able to respond and adapt to rapid changes in technology and consumer preferences.

The number of people who access the Internet through devices other than personal computers, including mobile phones, smart phones, handheld computers such as notebooks and tablets, video game consoles and television set-top devices, has increased dramatically in the past few years. The smaller screen size, functionality and memory associated with some alternative devices may make the use of our website and purchasing our products more difficult; and the versions of our website developed for these devices may not be compelling to consumers. Each manufacturer or distributor may establish unique technical standards for its devices, and our website may not work or be viewable on these devices as a result. As new devices and new platforms are continually being released, it is difficult to predict the challenges we may encounter in developing versions of our website for use on these alternative devices and we may need to devote significant resources to the creation, support and maintenance of such devices. If we are unable to attract consumers to our website through these devices or are slow to develop a version of our website that is more compatible with alternative devices, we may fail to capture a significant share of consumers in the market for diamonds and fine jewelry, which could adversely affect our business.

Further, 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 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 levels. 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

Table of Contents

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 stock 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.

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

We are faced with the constant challenge of balancing our inventory levels with our ability to meet our customer needs. Based on internally generated projections, we purchase jewelry and jewelry components. These projections are based on many unknown assumptions around consumer demand, fashion trends, time to manufacture, pricing, etc. If these inventory projections are too high, our inventory may be too high, which may result in lower retail prices and gross margins, risk of obsolescence and harm to our financial results. Conversely, if these projections are too low, and we underestimate the consumer demand for our products, we are exposed to lost business opportunities which could have a material adverse effect on our business, results of operations, financial condition and cash flows. Additionally, as we increase our product offerings, we may be forced to increase inventory levels, which will increase our risks related to our inventory.

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 consumer finance company to provide financing to our customers. If this company is not able to meet our customer's needs for credit or otherwise adequately serve our customers or 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 have exposure to greater than anticipated tax liabilities.

We are subject to various federal, state and local taxes in both the United States and foreign jurisdictions. Significant judgment is required in evaluating and estimating worldwide provisions and accruals for these taxes. 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 audit in various jurisdictions, and such jurisdictions may assess additional tax liabilities, penalties and interest against us. Although we believe our estimates are reasonable, the ultimate outcome of a tax audit and any related litigation could be materially different from our tax provisions and accruals, and could have a material adverse effect on our financial results. Changes to tax laws, changes to interpretations of existing tax laws, and/or developments in an audit or litigation could have a material effect on our operating results and cash flow for the period or periods for which that change or development occurs, as well as for prior and subsequent periods. In addition, the imposition of additional tax obligations on our business by federal, state and local governments could create significant administrative burdens for us, decrease our future sales and harm our cash flow and operating results.

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 31%, 33% and 32% of our net

sales in the years ended January 3, 2016, January 4, 2015, and December 29, 2013, 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 fine jewelry, additional marketing, 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 costs 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 (first quarter) and Mother's Day (second quarter). 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 could substantially harm our business and results of operations.

Table of Contents

Unusual weather patterns could adversely affect the Company's performance.

Our operating results could be negatively impacted by unusual weather patterns. Frequent or unusually heavy snow, ice or rain storms, hurricanes, floods, tornadoes or extended periods of unseasonable temperatures could adversely affect our product availability, and ability to deliver products to our customers, which may harm our brand, lead to higher return rates and negatively impact our performance. Additionally, significant power outages may result in a loss of sales. Given the seasonality of our business, unusual weather in the fourth quarter may have a disproportionately larger impact on operating results for the fourth quarter and the full year.

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

A component of our strategy is to expand our product offerings beyond our current offerings. If we offer new products that are not accepted by consumers, our net sales may fall short of expectations, our brand and reputation could be adversely affected, and we may incur substantial expenses that are not offset by increased net sales. Expansion of our product lines may also increase our inventory levels and strain our management and operational resources.

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. Additionally, we recently opened a store in New York as part of our Webroom Concept. While this store differs from traditional retailers in that it does not carry inventory to sell to consumers, it does have some products on display, and we allow customers to pick-up and return products purchased online to the store. The opening of our store may increase our risk of theft. We have taken steps to prevent theft of our products. 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.

Our net sales consist exclusively of diamonds and fine jewelry, 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, customs with respect to engagement shift away from the presentation of diamond jewelry, or if there is a reduced rate of marriages, 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.

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 fine jewelry offerings must reflect the tastes and preferences of a wide range of consumers whose preferences may change regularly. There can be no assurance that the styles we offer will continue to be popular with consumers in the future. If our merchandise offerings are not 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.

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 images, features, compilation 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 or have applications pending for, “Blue Nile,” the BN logo, the Blue Nile BN stylized logo, “Build Your Own Ring,” “Build Your Own Five-Stone Ring,” “Build Your Own Three

Table of Contents

Stone Ring,” “Build Your Own Diamond Jewelry,” “Build Your Own Diamond Pendant,” “Build Your Own Earrings” and “Build Your Own Charm Bracelet” 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. In addition, we are the holder of a patent entitled “Computerized Search Technique, such as an Internet-Based Gemstone Search Technique” (U.S. Patent No. 8,271,521) and have several other U.S. patent applications pending at this time.

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. The regulation of domain names in the United States and in foreign countries is subject to change. Regulatory bodies have and may continue to establish additional top-level domains, appoint additional domain name registrars or modify the requirements for holding domain names. We may not be able to, or it may not be cost effective to, acquire or maintain all domain names that utilize the name Blue Nile in all of the countries in which we currently conduct or intend to conduct business. If we lose the ability to use a domain name, we could incur significant additional expenses to market our products within that country, including the development of new branding. This could substantially harm our business and results of operations.

Litigation or similar proceedings have been necessary in the past and 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.

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 patents 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.

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. These fees may increase over time, which would raise our operating costs and lower our operating margins.

Government regulation of the Internet and e-commerce is evolving and unfavorable changes, or failure by us to comply with applicable regulations, 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. Existing and future regulations and laws could impede the growth of the Internet, e-commerce or mobile commerce. These regulations and laws may involve 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. It is possible that general business regulations and laws, or those specifically governing the Internet or e-commerce, may be interpreted and applied in a manner that is inconsistent from one jurisdiction to another and may conflict with other rules or our

Table of Contents

practices. Further, as our products are exported and imported across national borders, the international movement of these products is subject to a myriad of rules, regulations, and governmental authorities. We cannot be sure that our practices have complied, comply or will comply fully with all such laws and regulations. Any failure, or perceived failure, by us to comply with any of these laws or regulations could result in damage to our reputation, a loss in business and proceedings or actions against us by governmental entities or others. Any such proceeding or action could hurt our reputation, force us to spend significant amounts in defense of these proceedings, distract our management, increase our costs of doing business, decrease the use of our sites by consumers and suppliers and may result in the imposition of monetary liability. We may also be contractually liable to indemnify and hold harmless third parties from the costs or consequences of non-compliance with any such laws or regulations. In addition, it is possible that governments of one or more countries may seek to censor content available on our sites or may even attempt to completely block access to our sites. Adverse legal or regulatory developments could substantially harm our business. In particular, in the event that we are restricted, in whole or in part, from operating in one or more countries, our ability to retain or increase our customer base may be adversely affected, and we may not be able to maintain or grow our net revenue and expand our business as anticipated.

Our use of open source software may pose particular risks to our proprietary software and systems.

We use open source software in our software and systems and will use open source software in the future. The licenses applicable to open source software may require that the source code subject to the license be made available to the public and that any modifications or derivative works to certain open source software continue to be licensed under open source licenses. From time to time, we may face claims from third parties claiming infringement of their intellectual property rights, or demanding the release or license of the open source software or derivative works that we developed using such software (which could include our proprietary source code) or otherwise seeking to enforce the terms of the applicable open source license. These claims could result in litigation and could require us to purchase a costly license, publicly release the affected portions of our source code, be limited in or cease using the implicated software unless and until we can re-engineer such software to avoid infringement or change the use of the implicated open source software. In addition to risks related to license requirements, use of certain open source software can lead to greater risks than use of third-party commercial software, as open source licensors generally do not provide warranties, indemnities or other contractual protections with respect to the software (for example, non-infringement or functionality). Our use of open source software may also present additional security risks because the source code for open source software is publicly available, which may make it easier for hackers and other third parties to determine how to breach our website and systems that rely on open source software. Any of these risks could be difficult to eliminate or manage, and, if not addressed, could have a material adverse effect on our business, financial condition and operating results.

We may need to implement additional finance and accounting systems, procedures and controls as we grow our business and organization to satisfy international and other 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. Additionally, as we expand internationally, we will be subject to international accounting and reporting requirements that are new to our business. Compliance with these and other new requirements may increase our costs and require additional management time and resources. We may need to implement additional or enhance our current finance and accounting systems, procedures and controls to satisfy new accounting and reporting requirements. 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.

Our failure to appropriately source or to ensure that our products are appropriately sourced may adversely impact our business.

Heightened consumer awareness on “conflict” diamonds, which are diamonds extracted from war-torn regions in Africa and sold by rebel forces to fund insurrection, may decrease demand for diamonds. 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 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 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.

Table of Contents

The Dodd-Frank Wall Street Reform and Consumer Protection Act contains provisions to improve transparency and accountability concerning the supply of certain minerals, known as conflict minerals, originating from the Democratic Republic of Congo (the “DRC”) and adjoining countries. As a result, in August 2012 the SEC adopted annual disclosure and reporting requirements for those companies who use conflict minerals mined from the DRC and adjoining countries in their products. We performed due diligence efforts in fiscal 2015 and will continue these efforts to adhere with the disclosure requirements. There may be costs associated with complying with these disclosure requirements, including those that may be incurred in conducting due diligence procedures to determine the sources of conflict minerals used in our products and other potential changes to products, processes or sources of supply as a consequence of such verification activities. The implementation of these rules could adversely affect the sourcing, supply and pricing of materials used in our products. As there may be only a limited number of suppliers offering conflict free conflict minerals, we cannot be sure that we will be able to obtain necessary conflict free conflict minerals from such suppliers in sufficient quantities or at competitive prices. Also, we may face reputational challenges if we determine that certain of our products contain minerals not determined to be conflict free or if we are unable to sufficiently verify the origins for all conflict minerals used in our products through the procedures we may implement.

## Item 1B. Unresolved Staff Comments

None.

## Item 2. Properties

As of January 3, 2016, we have the following significant operational facilities:

Location	Approximate Square Feet	Purpose	Lease Termination Date
Seattle, Washington	40,000	Office space	August 2021
Seattle, Washington	27,000	Warehouse space	October 2019
Dublin, Ireland	10,000	Office and warehouse space	December 2016

Certain of the leases include renewal provisions at our option. We believe that the facilities housing our fulfillment centers will be adequate to meet our current requirements for our operations and that suitable additional or substitute space will be available as needed.

## Item 3. Legal Proceedings

See discussion of legal proceedings in Note 4 to the consolidated financial statements included in Item 8 of this Annual Report on Form 10-K.

## Item 4. Mine Safety Disclosures

Not applicable.

## PART II

## Item 5. Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Market Information and Dividend Policy

Our common stock is quoted on The NASDAQ Stock Market LLC under the symbol "NILE." On February 19, 2016, we had approximately 30 stockholders of record.

The following table sets forth the high and low sales prices of our common stock for fiscal years 2015 and 2014. The quotations are as reported in published financial sources.

Table of Contents

	High	Low
Fiscal year 2015:		
First Quarter	\$35.89	\$26.59
Second Quarter	\$31.12	\$26.62
Third Quarter	\$35.41	\$29.68
Fourth Quarter	\$39.00	\$31.15
Fiscal year 2014:		
First Quarter	\$49.14	\$32.60
Second Quarter	\$36.16	\$27.45
Third Quarter	\$30.39	\$23.10
Fourth Quarter	\$37.50	\$27.57

On February 9, 2016, the Company's board of directors declared a special cash dividend of \$0.70 per share of common stock. This dividend will be paid on March 07, 2016 to shareholders of record at the close of business on February 22, 2016. On an annual basis, the Company will reassess its use of capital and any future payment of dividends will be at the discretion of our board of directors. The Company's equity incentive plan and related form of award agreement provide that in connection with the declaration of such a special dividend, the outstanding restricted stock units ("RSUs") shall be automatically credited with dividend equivalents to reflect dividends declared and paid and such dividend equivalents will be subject to all the terms and conditions, including vesting, of the awards to which they relate. The exact number of dividend equivalents is indeterminate at this time, but will be determined at the time of the payment date depending on the trading price of our stock on such date.

## Performance Measurement Comparison (1)

The following graph compares the total cumulative stockholder return on the Company's common stock with the total cumulative return of the NASDAQ Market Index and the RDG Internet Composite Index for the five-year period ending on January 3, 2016, our 2015 fiscal year end. Historical stock price performance should not be relied upon as an indication of future stock price performance.



Table of Contents

(1) This Section is not “soliciting material,” is not deemed “filed” with the SEC and is not to be incorporated by reference in any of our filings under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended, whether made before or after the date hereof and irrespective of any general incorporation language in any such filing.

(2) Assumes \$100 was invested on January 2, 2011 at the closing price on this day, in Blue Nile’s common stock and on December 31, 2010 for each index, and all dividends have been reinvested. No cash dividends have been declared on Blue Nile’s common stock. Stockholder returns over the indicated period should not be considered indicative of future stockholder returns.

Item 6. Selected Consolidated Financial Data

Blue Nile's fiscal year ends on the Sunday nearest to December 31. The fiscal year 2015 ended on January 3, 2016 and included 52 weeks. The fiscal year ended January 4, 2015 included 53 weeks with the 53<sup>rd</sup> week falling in our fourth quarter. Fiscal years ended December 29, 2013, December 30, 2012, and January 1, 2012 each included 52 weeks.

The table below shows selected consolidated financial data for each of our fiscal years ended January 3, 2016, January 4, 2015, December 29, 2013, December 30, 2012, and January 1, 2012. The consolidated statements of operations data and the additional operating data for each of the fiscal years ended January 3, 2016, January 4, 2015 and December 29, 2013 and the consolidated balance sheets as of January 3, 2016 and January 4, 2015 are derived from our audited consolidated financial statements included elsewhere in this Annual Report on Form 10-K. The consolidated statements of operations for the fiscal years ended December 30, 2012 and January 1, 2012 and the consolidated balance sheet data as of December 29, 2013, December 30, 2012, and January 1, 2012, are derived from audited consolidated financial statements not included in this Annual Report on Form 10-K.

You should read the following selected consolidated financial and operating information together with “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and our audited consolidated financial statements and the related notes included elsewhere in this Annual Report on Form 10-K. The historical results presented below are not

Table of Contents

necessarily indicative of future results. See Note 10 of the related notes to our consolidated financial statements included in Item 8 of this Annual Report on Form 10-K for the calculation of weighted average shares outstanding used in computing basic and diluted net income per share.

23

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Table of Contents

BLUE NILE, INC.

## SELECTED CONSOLIDATED FINANCIAL DATA

	Year Ended January 3, 2016 (52 Weeks)	Year Ended January 4, 2015 (53 Weeks)	Year Ended December 29, 2013 (52 Weeks)	Year Ended December 30, 2012 (52 Weeks)	Year Ended January 1, 2012 (52 Weeks)	
(In thousands, except per share data)						
Consolidated Statements of Operations Data:						
Net sales	\$480,057	\$473,516	\$450,008	\$400,035	\$348,013	
Gross profit	92,346	86,642	83,651	75,058	72,132	
Selling, general and administrative expenses	76,296	72,430	69,343	62,771	55,213	
Operating income	16,050	14,212	14,308	12,287	16,919	
Income before income taxes	16,112	14,619	14,565	12,966	17,245	
Income tax expense	5,578	4,888	3,690	4,574	5,895	
Net income	\$10,534	\$9,731	\$10,875	\$8,392	\$11,350	
Basic net income per share	\$0.90	\$0.80	\$0.87	\$0.64	\$0.80	
Diluted net income per share	\$0.90	\$0.80	\$0.85	\$0.63	\$0.77	
Shares used in computing basic net income per share	11,668	12,144	12,540	13,204	14,182	
Shares used in computing diluted net income per share	11,759	12,209	12,760	13,427	14,675	
Additional Operating Data:						
Net cash provided by operating activities	\$8,036	\$17,208	\$23,438	\$34,444	\$15,454	
Gross margin	19.2	% 18.3	% 18.6	% 18.8	% 20.7	%
Selling, general and administrative expenses as a percentage of net sales	15.9	% 15.3	% 15.4	% 15.7	% 15.8	%
	As of January 3, 2016	As of January 4, 2015	As of December 29, 2013	As of December 30, 2012	As of January 1, 2012	
(In thousands)						
Consolidated Balance Sheet Data:						
Cash and cash equivalents	\$86,542	\$91,186	\$115,942	\$87,017	\$89,391	
Accounts receivable	4,645	3,708	3,526	3,485	4,867	
Inventories	46,376	41,668	34,530	33,270	29,267	
Accounts payable	121,917	128,675	122,322	116,209	95,590	
Working capital(1)	4,572	(2,905)	) 22,160	(3,953)	) 19,278	
Total assets	157,414	157,334	176,925	145,901	143,025	
Total long-term obligations	4,382	2,640	2,917	2,838	2,745	
Total stockholders' equity	18,456	13,703	40,605	14,109	35,024	

(1)

Working capital consists of total current assets, including cash and cash equivalents, less total current liabilities. In November 2015, the FASB issued Accounting Standards Update No. 2015-17, Income Taxes (Topic 740): Balance Sheet Classification of Deferred Taxes, which simplifies the presentation of deferred income taxes by requiring deferred tax assets and liabilities to be classified as noncurrent on the balance sheet. We early-adopted this standard retrospectively and reclassified current deferred income tax assets to noncurrent deferred income tax assets for all previous periods presented. As a result of the reclassifications, working capital decreased for all previous periods presented.

Table of Contents

## Non-GAAP Financial Measures

To supplement our consolidated financial statements presented in accordance with generally accepted accounting principles (“GAAP”), we use non-GAAP free cash flow as a measure of financial performance. We define non-GAAP free cash flow as net cash provided by (used in) operating activities less cash outflows for purchases of fixed assets, including internal use software and website development. We report sales information in accordance with GAAP. Internally, management monitors its sales performance on a non-GAAP basis that eliminates the positive or negative effects that result from translating international sales into U.S. dollars (the “constant exchange rate basis”). Our management does not itself, nor does it suggest that investors should, consider such non-GAAP financial measures in isolation from, or as a substitute for, financial information prepared in accordance with GAAP. Investors should also note that the non-GAAP financial measures used by us may not be the same non-GAAP financial measures, and may not be calculated in the same manner, as that of other companies. Whenever we use such non-GAAP financial measures, we provide a reconciliation of non-GAAP financial measures to the most closely applicable GAAP financial measures. Investors are encouraged to review the related GAAP financial measures and the reconciliation of these non-GAAP financial measures to their most directly comparable GAAP financial measures.

A reconciliation of differences of non-GAAP free cash flow from the comparable GAAP measure of net cash provided by operating activities is as follows (in thousands):

	Year Ended January 3, 2016 (52 Weeks)	Year Ended January 4, 2015 (53 Weeks)	Year Ended December 29, 2013 (52 Weeks)
Net cash provided by operating activities	\$8,036	\$17,208	\$23,438
Purchases of fixed assets, including internal-use software and website development	(3,755	) (3,771	) (5,528
Non-GAAP free cash flow	\$4,281	\$13,437	\$17,910

The following table reconciles year-over-year international sales percentage increases (decreases) from the GAAP sales measures to the non-GAAP constant exchange rate basis:

Year ended January 3, 2016 (52 Weeks)	Year over year growth	Effect of foreign exchange movements	Year over year growth on constant exchange rate basis
International net sales	1.0	% (8.9	)% 9.9
Year ended January 4, 2015 (53 Weeks)	Year over year growth	Effect of foreign exchange movements	Year over year growth on constant exchange rate basis
International net sales	10.8	% (3.2	)% 14.0
Year ended December 29, 2013 (52 Weeks)	Year over year growth	Effect of foreign exchange movements	Year over year growth on constant exchange rate basis
International net sales	17.3	% (2.9	)% 20.2



## Table of Contents

### Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion should be read in conjunction with the consolidated financial statements and related notes which appear elsewhere in this Annual Report on Form 10-K. This discussion contains forward-looking statements that involve risks and uncertainties. Our actual results could differ materially from those anticipated in these forward-looking statements as a result of various factors, including those discussed below and elsewhere in this Annual Report on Form 10-K, particularly under the heading "Item 1A. Risk Factors."

#### Management Overview

Blue Nile is a leading online retailer of high-quality diamonds and fine jewelry. We offer our products for sale through the Blue Nile website in over 40 countries and territories throughout the world. We believe that our extensive and unique product selection, connection with our customers through our marketing and customer service efforts, and the value we provide to our customers through our competitive pricing will result in increasing our sales and market share both domestically and internationally. Our primary focus is on growing our business by driving profitability through unparalleled quality, selection and value to consumers and delivering exceptional customer service. Our online business model allows us to avoid many of the costs that are typically incurred by traditional physical retail stores. As a result, we are able to realize lower gross profit margins while remaining profitable and providing value to our customers through lower retail prices.

Our objective is to maximize our revenue and profitability and increase market share both domestically and internationally by offering exceptional value and service to our customers through a high-quality customer experience that leverages supply chain efficiencies, an efficient cost structure and offering excellent customer service. We have established and will continue to refine our scalable, capital-efficient business model that enables growth with lower working capital requirements than traditional store-based jewelry retailers. We also optimize the cash flow dynamics of our business by managing inventory balances along with vendor payment terms. Over the longer term, our goal is to increase revenues, profit, and cash flow by leveraging our relatively low fixed cost technology and operations infrastructure as we achieve sales increases. Our long-term financial focus is primarily on sustainable growth in free cash flow, a non-GAAP financial measure. Non-GAAP free cash flow is primarily driven by increasing our operating income and efficiently managing working capital and capital expenditures. Increases in operating income primarily result from increases in sales through our website, improvements in operating margins through, in part, to efficient management of operating costs, offset by the investments that we make in longer-term strategic initiatives.

#### Differentiating Factors and Value Proposition

Our innovative business model is designed to deliver exceptional value and service to customers. A significant portion of our revenues is derived through sales of engagement rings or jewelry products that feature a diamond. We have developed relationships with a large number of diamond suppliers with whom we have exclusive agreements as an online retailer. This allows us to offer our customers access to a large selection of high-quality diamonds through our website that we typically do not hold in inventory. In most cases, we purchase diamonds from our suppliers only as our customers place orders with us. As a result, we do not incur the significant costs that would be incurred by traditional physical retail stores to carry high levels of diamond inventory. Our efficient operating model also provides for negative working capital benefits, since payments are received from customers within a few days of shipment of their order, but our vendor payment terms are typically in the 30-120 day range.

In addition to the working capital benefits of our model, the significant volume of diamonds that we purchase enhances our ability to buy from our suppliers at the best and lowest prices. We are able to pass these lower costs on to consumers, further increasing our value proposition.

### Focus on Profitable Growth

In 2015, we focused on accelerating the sales growth rate of our business through enhancements to our user experience, development of our engagement and non-engagement product lines, and expansion of our international operations. We also invested in marketing to drive greater brand awareness and familiarity, utilized our growing acumen in data analytics to refine our pricing strategy and to grow our margins, and leveraged scale to source products in ways that provide exceptional quality and value to our customers. We also tested a limited roll-out of a small retail storefront as part of our Webroom Concept, to determine if physical presence in targeted markets encourage more customers to buy online from us.

We believe that value is one of the most important drivers of engagement sales, and the current costs of diamonds is a significant factor to our growth rate. Generally, we purchase our diamonds on a real time basis from our suppliers when a



## Table of Contents

customer places an order for a specific diamond. When the cost of diamonds is relatively steady or declines, we believe that our business benefits because we are able to immediately pass those lower costs on to consumers. In periods of rapidly rising diamond costs, the value that we are able to provide to customers compared to our brick and mortar retail competitors may not be as compelling and our revenue as well as gross margin may suffer as we may choose to offset the inflationary impact of these changes. Regardless of diamond pricing dynamics, we will remain focused on growing sales by utilizing our aggressive retail pricing, developing and expanding our product lines as well as deepening our supply chain, and delivering a compelling website experience across all devices.

The total addressable market for the sale of non-engagement products is much greater than that for engagement, and we believe our brand is well-positioned to gain market share over time. To further drive growth in our non-engagement category, we will continue to expand a refined assortment of wedding bands, diamond jewelry and fashion jewelry, offer branded designs, and utilize disruptive and innovative technology such as the responsive website to provide our non-engagement consumers with a compelling shopping experience.

As part of our plan to accelerate growth of our international sales, we extended our capabilities into markets with the highest potential for growth. We believe that the Asia-Pacific market, specifically Greater China, represents a significant long-term opportunity for us. We have and will continue to increase our investments in personnel, infrastructure, fulfillment capabilities, product selection, marketing and enhancing the user experience to drive growth and gain market share.

Investments during 2015 have increased our selling, general and administrative expenses compared to last year. We invested in marketing vehicles to drive brand awareness as well as in the development of technology to enhance the user experience and in infrastructure to expand our ability to serve international customers. We believe that these investments will lead to increased growth in all categories of our business and provide higher profitability over the long-term.

### Critical Accounting Estimates

The preparation of our consolidated financial statements requires that we make certain estimates and judgments that affect amounts reported and disclosed in our consolidated financial statements and related notes. We base our estimates on historical experience and on other assumptions that we believe to be reasonable under the circumstances. Actual results may differ from these estimates. The following are the critical accounting policies that we believe require significant estimation and management judgment.

### Revenue Recognition

We recognize revenue and the related gross profit on the date on which ownership passes from Blue Nile to our customers, net of estimated provision for returns and promotional discounts excluding sales taxes. Our returns allowance is estimated based on our historical product return rates and current economic conditions, and actual returns could differ from our recorded amount.

### Inventory

Our diamond and fine jewelry inventories are valued at the lower of cost or market, using the specific identification method for diamonds and weighted average cost method for fine jewelry. This valuation requires us to make assumptions based on current information available, the age of the merchandise, anticipated demand, customer preferences and fashion trends. Some of these assumptions are inherently uncertain and changes in our estimate of our value of inventory may result in material write-downs in the future.

## Results of Operations

Blue Nile's fiscal year ends on the Sunday nearest to December 31. The fiscal year 2015 ended on January 3, 2016 and included 52 weeks. The fiscal year ended January 4, 2015 included 53 weeks with the 53<sup>rd</sup> week falling in our fourth quarter. Fiscal years ended December 29, 2013, December 30, 2012 and January 1, 2012 included 52 weeks.

The following table presents our historical operating results for the periods indicated as a percentage of net sales:

Table of Contents

	Year Ended January 3, 2016 (52 Weeks)	Year Ended January 4, 2015 (53 Weeks)	Year Ended December 29, 2013 (52 Weeks)		
Net sales	100.0	% 100.0	% 100.0	%	
Gross profit	19.2	% 18.3	% 18.6	%	
Selling, general and administrative expenses	15.9	% 15.3	% 15.4	%	
Operating income	3.3	% 3.0	% 3.2	%	
Other income, net	—	% 0.1	% —	%	
Income before income taxes	3.3	% 3.1	% 3.2	%	
Income tax expense	1.2	% 1.0	% 0.8	%	
Net income	2.1	% 2.1	% 2.4	%	

The following describes certain items set forth in our consolidated statements of operations:

**Net Sales.** Substantially all of our net sales consist of diamonds and fine jewelry sold via the Internet, net of estimated returns. Historically, net sales have been higher in the fourth quarter as a result of higher consumer spending during the holiday season. We expect this seasonal trend to continue in the foreseeable future.

**Gross Profit.** Our gross profit consists of net sales less the cost of sales. Our cost of sales includes the cost of merchandise sold to customers, inbound and outbound shipping costs, depreciation on assembly-related assets, insurance on shipments and the costs incurred to set diamonds into ring, earring and pendant settings, including labor and related facilities costs. Our gross profit has fluctuated historically and we expect it to continue to fluctuate based primarily on our product acquisition costs, product mix and pricing decisions.

**Selling, General and Administrative Expenses.** Our selling, general and administrative expenses consist primarily of payroll and related benefit costs for our employees, stock-based compensation, marketing costs and credit card fees. These expenses also include certain facility-related costs, and fulfillment, customer service, technology and depreciation expenses, as well as professional fees and other general corporate expenses.

**Fiscal Year.** Our fiscal year generally ends on the Sunday closest to December 31. Each fiscal year consists of four 13-week quarters, with one extra week added in the fourth quarter every five to six years. The fiscal year 2014 included one extra week in the fourth quarter, or 53 weeks for the fiscal year, as a result of our 4-4-5 retail reporting calendar.

The following table presents our historical operating results, including a comparison of the financial results for the periods indicated (dollars in thousands, except per share data):

Table of Contents

	Year Ended January 3, 2016  (52 Weeks)	Year Ended January 4, 2015  (53 Weeks)	Year Ended December 29, 2013  (52 Weeks)	Comparison of Year Ended January 3, 2016 to Year Ended January 4, 2015 \$ Change    % Change		Comparison of Year Ended January 4, 2015 to Year Ended December 29, 2013 \$ Change    % Change					
Net sales	\$480,057	\$473,516	\$450,008	\$6,541	1.4	%	\$23,508	5.2	%		
Cost of sales	387,711	386,874	366,357	837	0.2	%	20,517	5.6	%		
Gross profit	92,346	86,642	83,651	5,704	6.6	%	2,991	3.6	%		
Selling, general and administrative expenses	76,296	72,430	69,343	3,866	5.3	%	3,087	4.5	%		
Operating income	16,050	14,212	14,308	1,838	12.9	%	(96	)	(0.7	)%	
Other income, net:											
Interest income, net	86	117	107	(31	)	(26.5	)%	10	9.3	%	
Other income, net	(24	)	290	150	(314	)	(108.3	)%	140	93.3	%
Total other income, net	62	407	257	(345	)	(84.8	)%	150	58.4	%	
Income before income taxes	16,112	14,619	14,565	1,493	10.2	%	54	0.4	%		
Income tax expense	5,578	4,888	3,690	690	14.1	%	1,198	32.5	%		
Net income	\$10,534	\$9,731	\$10,875	\$803	8.3	%	\$(1,144	)	(10.5	)%	
Basic net income per share	\$0.90	\$0.80	\$0.87	\$0.10			\$(0.07	)			
Diluted net income per share	\$0.90	\$0.80	\$0.85	\$0.10			\$(0.05	)			

## Comparison of Fiscal Year Ended January 3, 2016 to Fiscal Year Ended January 4, 2015

## Net Sales

Net sales increased 1.4% in the fiscal year ended January 3, 2016, compared with the fiscal year ended January 4, 2015. The total net sales increase was due to an increase in average order value, partially offset by a decrease in orders. The increase in average order value was driven primarily by an increase in sales of non-engagement products at higher price points while the decrease in the number of orders was primarily due to a decrease in sales of non-engagement products at the lower price points. Excluding the impact of the additional week in fiscal year 2014, net sales increased by 2.7% for the fiscal year 2015 compared to the same period last year.

Net sales in the U.S. increased by 1.5% to \$398.2 million for the fiscal year ended January 3, 2016 compared with \$392.4 million for the fiscal year ended January 4, 2015. U.S. engagement net sales increased 1.3% to \$269.9 million for the fiscal year ended January 3, 2016 from \$266.4 million for the fiscal year ended January 4, 2015. The increase in U.S. engagement net sales was driven by an increase in orders partially offset by a decrease in average order value. The increase in the number of orders was driven by an increase in sales of products at the core price points (defined as those under \$25,000) while the decrease in average order value was primarily due to a decrease in sales of products at higher price points. U.S. non-engagement net sales increased 1.8% to \$128.3 million in the fiscal year ended January 3, 2016 from \$126.0 million in the fiscal year ended January 4, 2015. The increase in U.S. non-engagement net sales was primarily due to an increase in average order value partially offset by a decrease in the number of orders. The increase in average order value was due to an increase of sales of products at the higher price points while the

decrease in the number of orders was due to a decrease in sales of products at the core price points.

International net sales increased 1.0% to \$81.9 million for the year ended January 3, 2016, compared with \$81.1 million for the year ended January 4, 2015. Internally, we monitor our international sales performance on a non-GAAP basis which eliminates the positive or negative effects that result from translating international sales into U.S. dollars (“constant exchange rate basis”). International net sales growth was negatively impacted by 8.9% due to changes in foreign exchange rates in 2015 compared with the rates in effect during 2014. Excluding the impact of changes in foreign exchange rates, international sales increased 9.9% in the year ended January 3, 2016.

## Table of Contents

### Gross Profit

Gross profit increased \$5.7 million or 6.6% in the fiscal year ended January 3, 2016 compared with the fiscal year ended January 4, 2015. The increase in gross profit is due to the increase in net sales and gross margin. Gross margin increased to 19.2% in the year ended January 3, 2016 compared with 18.3% in the year ended January 4, 2015. The increase in gross margin is due to lower product costs resulting from data driven pricing models and a decline in the sales of high price point engagement products which carry lower gross margins.

Costs for our products are impacted by prices for diamonds and 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 diamonds and precious metals, which in turn, affect the gross margin that we realize from such products. While prices for diamonds and precious metals will continue to fluctuate based upon supply and demand, we cannot adequately predict the amount and timing of any such fluctuations. We expect that gross profit and gross margin will fluctuate in the future based on changes in product acquisition costs, particularly diamond prices, product mix and pricing decisions.

### Selling, General and Administrative Expenses

Selling, general and administrative expenses increased 5.3% to \$76.3 million in the fiscal year ended January 3, 2016 compared with \$72.4 million in the fiscal year ended January 4, 2015 due to several factors. Marketing and advertising costs increased approximately \$2.5 million, primarily due to increased spending on online marketing vehicles to increase brand awareness and to drive traffic to our website both domestically and internationally. Stock-based compensation expense increased by approximately \$0.7 million primarily due to a higher number of RSUs outstanding, partially offset by a decrease in the average grant date fair value of RSUs outstanding and a lower number of options outstanding at lower option fair values for the fiscal year ended January 3, 2016. Depreciation expense added approximately \$0.5 million to expenses due to an increase in capitalized internally developed software. Credit card interchange and payment processing fees increased approximately \$0.3 million in the fiscal year ended January 3, 2016 primarily due to higher sales. Bad debt expense increased by \$0.3 million. These increases were offset by a decrease in taxes and licenses of \$0.4 million primarily due to a favorable outcome of an indirect tax audit. As a percentage of net sales, selling, general and administrative expenses were 15.9% for the year ended January 3, 2016 compared to 15.3% for the year ended January 4, 2015 as selling, general and administrative expenses accelerated faster than sales.

### Other Income, Net

The decrease in other income, net in the fiscal year ended January 3, 2016 as compared with the fiscal year ended January 4, 2015 was primarily due to proceeds of approximately \$0.6 million from a favorable settlement resulting from a class action lawsuit related to interchange fees in the fiscal year ended January 4, 2015 that did not recur in the fiscal year ended January 3, 2016, as well as an increase in foreign currency losses partially offset by an increase in vendor incentives received in fiscal year ended January 3, 2016.

### Income Taxes

The effective income tax rate for the fiscal year ended January 3, 2016 was 34.6% as compared with 33.4% for the fiscal year ended January 4, 2015. The increase is primarily due to nondeductible executive compensation for the fiscal year 2015.

Comparison of Fiscal Year Ended January 4, 2015 to Fiscal Year Ended December 29, 2013

## Net Sales

Net sales increased 5.2% in the fiscal year ended January 4, 2015, compared with the fiscal year ended December 29, 2013, as a result of the execution of growth initiatives across our three main categories. The total net sales increase was due to an increase in average order value, partially offset by a decrease in orders. The increase in average order value was driven by an increase in engagement orders across all price points and non-engagement orders at higher price points while the decrease in orders is due to a decrease in non-engagement orders at the lower price points. Net sales for the additional week was estimated at \$5.9 million, which contributed 1.3% of growth for the fiscal year ended January 4, 2015.

Net sales in the U.S. increased by 4.1% to \$392.4 million for the fiscal year ended January 4, 2015 compared with \$376.8 million for the fiscal year ended December 29, 2013.

## Table of Contents

U.S. engagement net sales increased 4.1% to \$266.4 million for the fiscal year ended January 4, 2015 from \$255.8 million for the fiscal year ended December 29, 2013. U.S. engagement net sales for the additional week was estimated at \$2.9 million, which contributed 1.1% of growth for this category for the fiscal year ended January 4, 2015.

U.S. non-engagement net sales grew 4.2% to \$126.0 million in the fiscal year ended January 4, 2015 from \$121.0 million in the fiscal year ended December 29, 2013. U.S. non-engagement net sales for the additional week was estimated at \$1.8 million, which contributed 1.5% of growth for this category for the fiscal year ended January 4, 2015.

International net sales increased 10.8% to \$81.1 million for the year ended January 4, 2015, compared with \$73.2 million for the year ended December 29, 2013. Internally, we monitor our international sales performance on a non-GAAP basis which eliminates the positive or negative effects that result from translating international sales into U.S. dollars (“constant exchange rate basis”). International net sales growth was negatively impacted by 3.2% due to changes in foreign exchange rates in 2014 compared with the rates in effect during 2013. Excluding the impact of changes in foreign exchange rates, international sales increased 14.0% in the year ended January 4, 2015. International net sales for the additional week was estimated at \$1.2 million, which contributed 1.7% of growth for this category for the fiscal year ended January 4, 2015.

### Gross Profit

Gross profit increased \$3.0 million or 3.6% in the fiscal year ended January 4, 2015 compared with the fiscal year ended December 29, 2013. The increase in gross profit is due to the increase in net sales. Gross margin decreased to 18.3% in the year ended January 4, 2015 compared with 18.6% in the year ended December 29, 2013. The decrease in gross margin resulted primarily from mix shift to products at higher price points which carry lower mark-up as part of a strategy initiated in early 2014 to stimulate sales growth.

Costs for our products are impacted by prices for diamonds and 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 diamonds and precious metals, which in turn, affect the gross margin that we realize from such products. While prices for diamonds and precious metals will continue to fluctuate based upon supply and demand, we cannot adequately predict the amount and timing of any such fluctuations. We expect that gross profit and gross margin will fluctuate in the future based on changes in product acquisition costs, particularly diamond prices, product mix and pricing decisions.

### Selling, General and Administrative Expenses

Selling, general and administrative expenses increased 4.5% to \$72.4 million in the fiscal year ended January 4, 2015 compared with \$69.3 million in the fiscal year ended December 29, 2013 due to several factors. Compensation and benefits expenses increased \$1.0 million due to increased headcount to support key business initiatives and higher compensation rates of our employees. Marketing and advertising costs increased approximately \$0.9 million, primarily due to increased spending on online marketing vehicles to drive traffic to our website both domestically and internationally. Credit card interchange and payment processing fees increased approximately \$0.5 million in the fiscal year ended January 4, 2015 primarily due to higher sales. Depreciation expense added approximately \$0.5 million to expenses. These expense increases were partially offset by a decrease of approximately \$0.7 million in stock-based compensation expense primarily due to a lower number of options outstanding at lower option fair values for the fiscal year ended January 4, 2015. As a percentage of net sales, selling, general and administrative expenses were 15.3% for the year ended January 4, 2015 compared to 15.4% for the year ended December 29, 2013 as sales accelerated faster than selling, general and administrative expenses.



Other Income, Net

The increase in other income, net in the fiscal year ended January 4, 2015 as compared with the fiscal year ended December 29, 2013 was primarily due to proceeds of approximately \$0.6 million from a favorable settlement resulting from a class action lawsuit related to interchange fees.

Income Taxes

The effective income tax rate for the fiscal year ended January 4, 2015 was 33.4% as compared with 25.3% for the fiscal year ended December 29, 2013. The increase is primarily due to the domestic production activities income tax benefit recorded in the third quarter of 2013 claimed for tax years prior to 2013.

Table of Contents

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, cash equivalents 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.

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 expenditures. Working capital at any specific point in time is dependent upon many variables, including our operating results, seasonality, inventory management and the level of product assortment, the timing of cash receipts and payments, and vendor payment terms.

At January 3, 2016, we had a working capital of \$4.6 million, including cash and cash equivalents of \$86.5 million and inventory of \$46.4 million, partially offset by accounts payable and accrued liabilities totaling \$134.3 million. Current levels of cash and cash equivalents reflect fewer stock repurchases and proceeds from stock option exercises during fiscal year 2015 compared to fiscal year 2014. On February 17, 2015, the Company renewed its Credit Agreement (the "Credit Agreement") which provides for a \$40.0 million unsecured, revolving credit facility with an option to increase the credit limit to \$50.0 million. See discussion of the Credit Agreement in Note 13 to the consolidated financial statements included in Item 8 of this Annual Report on Form 10-K. We currently do not have any outstanding debt under the Credit Agreement. 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.

Net cash provided by operating activities was \$8.0 million in the fiscal year ended January 3, 2016 compared to net cash provided by operating activities of \$17.2 million in the fiscal year ended January 4, 2015. The decrease in cash provided by operating activities in the fiscal year ended January 3, 2016 was primarily attributable to changes in working capital offset by an increase in net income excluding non-cash charges to net income such as depreciation, amortization, and stock-based compensation.

Net cash provided by operating activities was \$17.2 million in the fiscal year ended January 4, 2015 compared to net cash provided by operating activities of \$23.4 million in the fiscal year ended December 29, 2013. The decrease in cash provided by operating activities in the fiscal year ended January 4, 2015 was primarily attributable to a decrease in working capital due to increased inventory specifically in-process and in-transit inventory. We experience greater cash flow from operations in our fourth quarter compared to other quarters due to the significant increase in revenue from our holiday sales. In the first quarter we typically have a significant pay down of our accounts payable balance accumulated during the fourth quarter holiday season.

Net cash of \$2.4 million was used in investing activities in the fiscal year ended January 3, 2016 which was primarily for purchases of property and equipment which includes capitalized costs to develop our website and internal-use software to support our operations. The cash used in investing activities during the fiscal year ended January 3, 2016 was partially offset by payments received on a note receivable of \$1.4 million. Net cash of \$3.8 million was used in investing activities in the fiscal year ended January 4, 2015 which was primarily for purchases of property and equipment which includes capitalized costs to develop our website and internal-use software to support our operations.

Our capital needs are generally minimal and include investments in technology and website enhancements, capital improvements to our leased warehouse and office facilities, and furniture and equipment. Additionally, we have the ability to reduce and/or delay capital investments in challenging economic conditions without significant disruption to our business or operations. Over the next 12 months, we do not expect purchases of property and equipment to exceed our historic levels.

Net cash of \$10.2 million was used in financing activities for the fiscal year ended January 3, 2016 related primarily to the repurchase of common stock of \$10.8 million partially offset by \$1.1 million of proceeds from stock option exercises. Net cash of \$38.1 million was used in financing activities for the fiscal year ended January 4, 2015 related primarily to the repurchase of common stock of \$40.3 million partially offset by \$2.4 million of proceeds from stock option exercises.

Since the inception of our stock buyback program in the first quarter of 2005 through January 3, 2016, we have repurchased approximately 9.4 million shares for a total of \$326.9 million. 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 are

Table of Contents

determined by management based on our evaluation of market conditions and other factors. Repurchases may also be made under a Rule 10b5-1 plan. We continually assess market conditions, our cash position, operating results, current forecasts and other factors when making decisions about stock repurchases. On November 2, 2015, our board of directors authorized the renewal of our stock repurchase program. Under this renewed program, we are authorized to repurchase up to \$100.0 million of our common stock over the 27 months following the approval date. As of January 3, 2016, \$100.0 million remained under the repurchase authorization.

On February 9, 2016, our board of directors declared a special cash dividend of \$0.70 per share of common stock. The dividend will be payable on March 7, 2016 to shareholders of record at the close of business on February 22, 2016. We determined the value of the dividend based on the level of earnings in fiscal year 2015. On an annual basis, we will reassess our use of capital, including investments in operations, strategic alternatives, share repurchases, and cash dividends. The Company's equity incentive plan and related form of award agreement provide that in connection with the declaration of such a special dividend, the outstanding RSUs shall be automatically credited with dividend equivalents to reflect dividends declared and paid and such dividend equivalents will be subject to all the terms and conditions, including vesting, of the awards to which they relate. The exact number of dividend equivalents is indeterminate at this time, but will be determined at the time of the payment date depending on the trading price of our stock on such date.

The following table summarizes our contractual obligations and the expected effect on liquidity and cash flows as of January 3, 2016 (in thousands):

Contractual Obligations	Total	Less than 1 Year	1-3 Years	3-5 Years	Over 5 Years
Operating leases	\$7,611	\$1,590	\$2,842	\$2,410	\$769
Financing obligation(1)	139	36	73	30	—
Purchase obligations(2)	1,050	1,050	—	—	—
Purchase obligations(3)	1,566	1,566	—	—	—
	\$10,366	\$4,242	\$2,915	\$2,440	\$769

During 2007, we made tenant improvements to our U.S. fulfillment center. Due to our financial involvement in the construction of the leased property, we recorded the building as property and equipment during the construction period. Upon completion, the transaction did not meet the criteria for sale-leaseback accounting, and accordingly, (1) has been recorded as a long-term financing obligation. On May 5, 2014, we entered into the Third Amendment to the Commercial Lease Agreement dated July 21, 2006 for this fulfillment center to extend the lease term to October 31, 2019.

(2)Includes open merchandise purchase orders at January 3, 2016.

(3)Includes commitments for advertising and marketing and other services at January 3, 2016.

We believe that our current cash and cash equivalent balances, cash flow from operations and our ability to borrow under the Credit Agreement will be sufficient to meet our anticipated operating and capital expenditure needs for at least the next 12 months. We currently do not have any outstanding debt under the Credit Agreement. 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.

## Off-Balance Sheet Arrangements

At January 3, 2016, we did not have any off-balance sheet arrangements or relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purposes entities, which are typically established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes.

#### Impact of Inflation

The effect of inflation and changing prices on our operations was not significant during the periods presented.

Table of Contents

Item 7A. Quantitative and Qualitative Disclosures About Market Risk

Foreign Currency Exchange Risk

The functional currency of most of our subsidiaries is the applicable local currency. Assets and liabilities 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 as a component of other comprehensive income within stockholders' equity.

We have foreign exchange risk related to foreign-denominated assets and liabilities of our subsidiaries. Based on the balances of our foreign-denominated subsidiaries assets and liabilities at January 3, 2016, January 4, 2015, and December 29, 2013, an assumed 10% negative currency movement would have resulted in additional losses of approximately \$0.2 million for the fiscal years ended January 3, 2016, January 4, 2015 and December 29, 2013.

We recognized gains and losses associated with transactions that are denominated in foreign currencies. We recorded a net loss resulting from foreign currency transactions of approximately \$1.0 million for the fiscal year ended January 3, 2016, \$0.8 million for the fiscal year ended January 4, 2015 and \$0.4 million for the fiscal year ended December 29, 2013, within other income, net in the consolidated statements of operations.

We have foreign exchange risk related to our VAT payables, tax receivables, cash and cash equivalents, and intercompany accounts receivables and payables denominated in various foreign currencies. Based on the balances of these accounts at January 3, 2016, January 4, 2015 and December 29, 2013, an assumed 10% adverse change to foreign exchange would result in additional losses of approximately \$0.5 million, \$0.3 million and \$0.2 million recorded to other income, net for fiscal years ended January 3, 2016, January 4, 2015 and December 29, 2013, respectively.

Interest Rate Risk

We are exposed to financial market risk that results primarily from fluctuations in interest rates. We maintain the majority of our cash, cash equivalents and short-term investments in accounts with major financial institutions within and outside the United States, in the form of demand deposits, money market accounts and other short-term investments. Deposits in these institutions may exceed the amounts of insurance provided, or deposits may not be covered by insurance. To date, we have not experienced any losses on our deposits of cash, cash equivalents and short-term investments.

The primary objective of our investment activities is to preserve principal while at the same time maximizing yields without significantly increasing risk. To achieve this objective, we invest in short-term, high-quality, interest-bearing securities. To minimize our exposure to an adverse shift in interest rates, we invest in short-term securities and maintain an average maturity of one year or less. If interest rates had averaged 100 basis points higher than they did in the year ended January 3, 2016, interest income for the year would have increased approximately \$0.5 million. If interest rates had averaged 100 basis points higher than they did in the year ended January 4, 2015, interest income for the year would have increased approximately \$0.6 million.

Table of Contents

Item 8. Financial Statements and Supplementary Data

Index to Consolidated Financial Statements

	Page
Financial Statements	
<u>Report of Independent Registered Public Accounting Firm</u>	<u>36</u>
<u>Consolidated Balance Sheets, as of January 3, 2016 and January 4, 2015</u>	<u>37</u>
<u>Consolidated Statements of Operations, for the fiscal years ended January 3, 2016, January 4, 2015 and December 29, 2013</u>	<u>38</u>
<u>Consolidated Statements of Comprehensive Income, for the fiscal years ended January 3, 2016, January 4, 2015 and December 29, 2013</u>	<u>39</u>
<u>Consolidated Statements of Changes in Stockholders' Equity, for the fiscal years ended January 3, 2016, January 4, 2015 and December 29, 2013</u>	<u>40</u>
<u>Consolidated Statements of Cash Flows, for the fiscal years ended January 3, 2016, January 4, 2015 and December 29, 2013</u>	<u>41</u>
<u>Notes to Consolidated Financial Statements</u>	<u>43</u>
<u>Selected Quarterly Financial Information (unaudited)</u>	<u>56</u>
Financial Statement Schedule	
<u>Schedule II, Valuation and Qualifying Accounts</u>	<u>58</u>
All other schedules are omitted because they are not applicable or the required information is shown in the financial statements or notes thereto.	

Table of Contents

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of  
Blue Nile, Inc.  
Seattle, Washington

We have audited the accompanying consolidated balance sheets of Blue Nile, Inc. and subsidiaries (the “Company”) as of January 3, 2016 and January 4, 2015, and the related consolidated statements of operations, comprehensive income, changes in stockholders’ equity, and cash flows for each of the three fiscal years in the period ended January 3, 2016. Our audits also included the financial statement schedule listed in the Index at Item 15. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Blue Nile, Inc. and subsidiaries at January 3, 2016 and January 4, 2015, and the results of their operations and their cash flows for each of the three fiscal years in the period ended January 3, 2016, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company’s internal control over financial reporting as of January 3, 2016, based on the criteria established in Internal Control-Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 1, 2016 expressed an unqualified opinion on the Company’s internal control over financial reporting.

/s/ Deloitte & Touche LLP  
Seattle, Washington  
March 1, 2016



Table of Contents

## BLUE NILE, INC.

## Consolidated Balance Sheets

(In thousands, except par value)

	January 3, 2016	January 4, 2015
Assets		
Current assets:		
Cash and cash equivalents	\$86,542	\$91,186
Trade accounts receivable	3,339	2,137
Other accounts receivable	706	1,571
Note receivable	600	—
Inventories	46,376	41,668
Prepays and other current assets	1,585	1,524
Total current assets	139,148	138,086
Property and equipment, net	10,530	10,422
Intangible assets, net	82	103
Deferred income taxes	5,089	4,187
Note receivable	—	2,000
Other investments	2,280	2,280
Other assets	285	256
Total assets	\$157,414	\$157,334
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	\$121,917	\$128,675
Accrued liabilities	12,336	11,992
Current portion of long-term financing obligation	33	32
Current portion of deferred rent	290	292
Total current liabilities	134,576	140,991
Long-term financing obligation, less current portion	455	489
Deferred rent, less current portion	1,697	1,982
Unearned income	1,988	—
Other long-term liabilities	242	169
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; 21,714 shares and 21,615 shares issued, respectively; 11,575 shares and 11,859 shares outstanding, respectively	22	22
Additional paid-in capital	232,148	227,146
Accumulated other comprehensive loss	(239	) (236
Retained earnings	114,023	103,489
Treasury stock, at cost; 10,139 shares and 9,756 shares outstanding, respectively	(327,498	) (316,718
Total stockholders' equity	18,456	13,703
Total liabilities and stockholders' equity	\$157,414	\$157,334

The accompanying notes are an integral part of these consolidated financial statements  
37

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Table of Contents

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

	Year Ended January 3, 2016	Year Ended January 4, 2015	Year Ended December 29, 2013
Net sales	\$480,057	\$473,516	\$450,008
Cost of sales	387,711	386,874	366,357
Gross profit	92,346	86,642	83,651
Selling, general and administrative expenses	76,296	72,430	69,343
Operating income	16,050	14,212	14,308
Other income, net:			
Interest income, net	86	117	107
Other (loss) income, net	(24	) 290	150
Total other income, net	62	407	257
Income before income taxes	16,112	14,619	14,565
Income tax expense	5,578	4,888	3,690
Net income	\$10,534	\$9,731	\$10,875
Basic net income per share	\$0.90	\$0.80	\$0.87
Diluted net income per share	\$0.90	\$0.80	\$0.85

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

38

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Table of Contents

BLUE NILE, INC.  
 Consolidated Statements of Comprehensive Income  
 (In thousands)

	Year Ended January 3, 2016	Year Ended January 4, 2015	Year Ended December 29, 2013
Net income	\$10,534	\$9,731	\$10,875
Other comprehensive (loss) income:			
Foreign currency translation adjustments	(3 )	(210 )	74
Total comprehensive income	\$10,531	\$9,521	\$10,949

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

39

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Table of Contents

## BLUE NILE, INC.

## Consolidated Statements of Changes in Stockholders' Equity

(In thousands)

	Common Stock		Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock		Total Stockholders' Equity
	Shares	Amount				Shares	Amount	
Balance, December 31, 2012	20,752	\$21	\$197,282	\$82,883	\$ (100 )	(8,249 )	\$(265,977)	\$ 14,109
Net income	—	—	—	10,875	—	—	—	10,875
Other comprehensive income	—	—	—	—	74	—	—	74
Tax deficiency from share-based awards	—	—	(583 )	—	—	—	—	(583 )
Exercise of common stock options	716	1	21,376	—	—	—	—	21,377
Issuance of common stock to directors	2	—	80	—	—	—	—	80
Vesting of restricted stock units	10	—	—	—	—	—	—	—
Stock-based compensation	—	—	5,106	—	—	—	—	5,106
Repurchase of common stock	—	—	—	—	—	(299 )	(10,433 )	(10,433 )
Balance, December 29, 2013	21,480	22	223,261	93,758	(26 )	(8,548 )	(276,410 )	40,605
Net income	—	—	—	9,731	—	—	—	9,731
Other comprehensive loss	—	—	—	—	(210 )	—	—	(210 )
Tax deficiency from share-based awards	—	—	(2,713 )	—	—	—	—	(2,713 )
Exercise of common stock options	99	—	2,413	—	—	—	—	2,413
Issuance of common stock to directors	3	—	80	—	—	—	—	80
	42	—	—	—	—	—	—	—

Vesting of restricted stock units										
Shares withheld related to net share settlement of share-based awards	(9	)	—	(282	)	—	—	(282	)	
Stock-based compensation	—	—	4,387	—	—	—	—	4,387		
Repurchase of common stock	—	—	—	—	—	(1,208	)	(40,308	)	
Balance, January 4, 2015	21,615	22	227,146	103,489	(236	)	(9,756	)	(316,718	)
Net income	—	—	—	10,534	—	—	—	—	10,534	
Other comprehensive loss	—	—	—	—	(3	)	—	—	(3	)
Tax deficiency from share-based awards	—	—	(735	)	—	—	—	—	(735	)
Exercise of common stock options	35	—	1,104	—	—	—	—	—	1,104	
Issuance of common stock to directors	1	—	40	—	—	—	—	—	40	
Vesting of restricted stock units	81	—	—	—	—	—	—	—	—	
Shares withheld related to net share settlement of share-based awards	(18	)	—	(558	)	—	—	—	(558	)
Stock-based compensation	—	—	5,151	—	—	—	—	—	5,151	
Repurchase of common stock	—	—	—	—	—	(383	)	(10,780	)	
Balance, January 3, 2016	21,714	\$22	\$232,148	\$114,023	\$(239	)	(10,139	)	\$(327,498)	\$18,456

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

Table of Contents

BLUE NILE, INC.  
 Consolidated Statements of Cash Flows  
 (In thousands)

	Year Ended January 3, 2016	Year Ended January 4, 2015	Year Ended December 29, 2013
Operating activities:			
Net income	\$10,534	\$9,731	\$10,875
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	3,858	3,607	3,141
Gain on disposal of property and equipment	—	—	(7)
Stock-based compensation	5,081	4,361	5,028
Deferred income taxes	(902)	) 2,321	2,204
Tax deficiency from share-based awards	(735)	) (2,713)	) (583)
Excess tax benefit from share-based awards	(66)	) (195)	) (361)
Changes in assets and liabilities:			
Receivables	(311)	) (182)	) (41)
Inventories	(4,708)	) (7,138)	) (1,260)
Prepaid income taxes	—	247	(247)
Prepaid expenses and other assets	(90)	) (216)	) (218)
Accounts payable	(6,743)	) 6,323	6,432
Accrued liabilities	344	1,241	(1,688)
Unearned income	1,988	—	—
Deferred rent and other	(214)	) (179)	) 163
Net cash provided by operating activities	8,036	17,208	23,438
Investing activities:			
Purchases of property and equipment	(3,755)	) (3,771)	) (5,528)
Purchase of other investments	—	—	(280)
Payments received on note receivable	1,400	—	—
Net cash used in investing activities	(2,355)	) (3,771)	) (5,808)
Financing activities:			
Repurchase of common stock	(10,780)	) (40,308)	) (10,433)
Proceeds from stock option exercises	1,078	2,413	21,377
Taxes paid for net share settlement of share-based awards	(558)	) (282)	) —
Excess tax benefit from share-based awards	66	195	361
Principal payments under long-term financing obligation	(33)	) (104)	) (60)
Net cash (used in) provided by financing activities	(10,227)	) (38,086)	) 11,245
Effect of exchange rate changes on cash and cash equivalents	(98)	) (107)	) 50
Net (decrease) increase in cash and cash equivalents	(4,644)	) (24,756)	) 28,925
Cash and cash equivalents, beginning of period	91,186	115,942	87,017
Cash and cash equivalents, end of period	\$86,542	\$91,186	\$115,942

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

41

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Table of Contents

BLUE NILE, INC.  
Consolidated Statements of Cash Flows  
(In thousands)

	Year Ended January 3, 2016	Year Ended January 4, 2015	Year Ended December 29, 2013
Supplemental disclosure of cash flow information:			
Cash paid for income taxes	\$6,736	\$3,675	\$4,965

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

42

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Table of Contents

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 and fine jewelry, the Company provides education, guidance and support to enable customers to more effectively learn about and purchase diamonds and 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 through its website at [www.bluenile.com](http://www.bluenile.com).

Fiscal Year

The Company’s fiscal year ends on the Sunday closest to December 31. Each fiscal year consists of four 13-week quarters, with one extra week added in the fourth quarter every five to six years. The Company's fiscal year 2015 ended January 3, 2016 included 52 weeks.

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. 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 (“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, accounting for taxes, and inventory valuation. Actual results could differ materially from those estimates.

Foreign Currency

The functional currency of most of the Company’s subsidiaries is the applicable local currency. Assets and liabilities 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 as a component of other accumulated comprehensive income within stockholders’ equity.

The Company also recognizes gains and losses associated with transactions that are denominated in foreign currencies. The Company recorded a net loss resulting from foreign currency transactions of approximately \$1.0 million for the fiscal year ended January 3, 2016, approximately \$0.8 million for the fiscal year ended January 4, 2015 and approximately \$0.4 million for the fiscal year ended December 29, 2013, within other income, net in the consolidated statements of operations.

Concentration of Risk

The Company maintains the majority of its cash and cash equivalents in accounts with six major financial institutions within and outside the United States, in the form of demand deposits, money market accounts, and time deposits. Deposits in these institutions may exceed the amounts of insurance provided, or deposits may not be covered by insurance. The Company has not experienced losses on its deposits of cash and cash equivalents. The Company's trade accounts receivable are primarily derived from credit card purchases from customers and the majority are settled within two business days.

The Company's ability to acquire diamonds and fine jewelry is dependent on its relationships with various suppliers from whom it purchases diamonds and fine jewelry. The Company has reached agreements with certain suppliers to provide access to their inventories of diamonds for its customers, but the terms of these agreements are limited and do not govern the purchase of diamonds for its inventory. Purchase concentration by major supply vendor in fiscal year ended January 3, 2016 with comparative information for fiscal years ended January 4, 2015 and December 29, 2013, is as follows:

Table of Contents

BLUE NILE, INC

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

	Year Ended			
	January 3, 2016	January 4, 2015	December 29, 2013	
Vendor A	8	% 7	% 10	%
Vendor B	6	% 6	% 5	%
Vendor C	5	% 5	% 5	%
	19	% 18	% 20	%

**Cash and Cash Equivalents**

The Company considers all highly liquid investments with maturities of three months or less, from the date of purchase, to be cash equivalents.

**Inventories**

The Company's diamond and fine jewelry inventories are valued at the lower of cost or market, using the specific identification method for diamonds and weighted average cost method for fine jewelry. The Company lists loose diamonds on its website that are typically not included in inventory until the Company receives a customer order for those diamonds. Upon receipt of a customer order, the Company purchases a specific diamond and records it in inventory until it is delivered to the customer, at which time the revenue from the sale is recognized and inventory is relieved.

To determine if the cost of the Company's inventory should be written down, current and anticipated demand, customer preferences, age of the merchandise and fashion trends are considered. This write-down is equal to the difference between the cost of inventory and its estimated market value. The Company recorded inconsequential write-downs for the fiscal years ended January 3, 2016, January 4, 2015 and December 29, 2013.

**Property and Equipment**

Property and equipment are stated at cost less accumulated depreciation. Maintenance and repairs are expensed as incurred. Depreciation expense is calculated on a straight-line basis over the estimated useful lives of the related assets. The cost and related accumulated depreciation of assets sold or otherwise disposed of are removed from the accounts and the related gain or loss is reported in the statement of operations. Estimated useful lives by major asset category are as follows:

Asset	Life (in years)
Software	2-5
Computers and equipment	2-5
Leasehold improvements	Shorter of lease term or asset life
Building	Shorter of lease term or asset life
Furniture and fixtures	5-7

**Capitalized Software**

The Company capitalizes costs to develop its website and internal-use software and amortizes such costs on a straight-line basis over the estimated useful life of the software once it is available for use. Costs related to the design

and maintenance of internal-use software and website development are expensed as incurred.

#### Impairment of Long-Lived Assets

The Company reviews the carrying value of its long-lived assets, including property and equipment and definite-lived intangible assets, whenever events or changes in circumstances indicate that the carrying value may not be recoverable. To the extent the estimated future cash inflows attributable to the assets, less estimated future cash outflows, are less than the carrying amount, an impairment loss would be recognized. The Company did not record an impairment loss for long-lived assets for the fiscal years ended January 3, 2016, January 4, 2015 or December 29, 2013.

Table of Contents

BLUE NILE, INC

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Amortizable Intangible Assets

Intangible assets are recorded at cost and consist primarily of the costs incurred to acquire licenses and other similar agreements with finite lives. The gross carrying amount of these licenses was approximately \$533,000 at both January 3, 2016 and January 4, 2015. Accumulated amortization was approximately \$485,000 at January 3, 2016 and \$464,000 at January 4, 2015. Amortization expense was approximately \$22,000 in the fiscal year ended January 3, 2016, \$37,000 in the fiscal year ended January 4, 2015 and \$55,000 in the fiscal year ended December 29, 2013. Amortization expense is estimated to be \$19,000 in fiscal 2016, \$14,000 in fiscal 2017, \$9,000 in fiscal 2018, \$3,000 in fiscal 2019, \$1,000 in fiscal 2020 and \$2,000 thereafter.

Note Receivable and Other Investments

The Company holds a minority ownership of a privately-held company in the form of convertible preferred shares, purchased for an aggregate amount of \$2.0 million, which we account for under the cost method of accounting.

The Company held a \$2.0 million note receivable (the "Note") from the same privately-held company. During the year ended January 3, 2016, the Company received payment of \$1.4 million on the principal amount, with the remainder of the principal collectable within a year. The interest rate changes over the term of the Note to LIBOR plus a predetermined rate per annum. The Note is recorded at its face amount on the Company's consolidated balance sheet.

The Company holds a minority ownership in another privately-held company in the form of common stock and warrants, purchased for \$280,000, which we account for under the cost method of accounting.

The Company reviews the investments for impairment when events and circumstances indicate that the decline in fair value of the asset below the carrying value is other-than-temporary. This evaluation consists of several qualitative and quantitative factors regarding the severity and duration of the unrealized loss as well as the Company's ability and intent to hold the investment until a forecasted recovery occurs. Additionally, the Company assesses whether it has plans to sell the security or it is more likely than not that the Company will be required to sell the investment before recovery of its amortized cost basis. Factors considered include recent and projected financial results and operating trends; publicly available information that may affect the value of the investment; duration and severity of the decline in value; and our strategy and intentions for holding the investment.

Fair Value of Financial Instruments

The carrying amounts for the Company's cash, cash equivalents, accounts receivable, note receivable, accounts payable and accrued liabilities approximate fair value due to their short maturities.

Treasury Stock

Treasury stock is recorded at cost and consists primarily of the repurchase of the Company's common stock in the open market.

Income Taxes

Deferred tax assets and liabilities are determined based on the differences between financial reporting and tax bases of assets and liabilities and are measured using the tax rates that will be in effect when the differences are expected to

reverse. Future tax benefits, such as return reserves, are recognized to the extent that realization of such benefits is considered to be more likely than not.

The Company utilizes a two-step approach to recognizing and measuring uncertain tax positions. The first step is to evaluate the tax position for recognition by determining if the weight of available evidence indicates it is more likely than not that the position will be sustained on audit, including resolution of related appeals or litigation processes, if any. The second step is to measure the tax benefit as the largest amount which is more than 50% likely of being realized upon ultimate settlement. The Company considers many factors when evaluating and estimating tax positions and tax benefits, which may require periodic adjustments and which may not accurately forecast actual outcomes. If applicable, interest and penalties related to unrecognized tax benefits are included in the provision for income taxes.

Table of Contents

BLUE NILE, INC

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Revenue Recognition

Net sales consist of products sold via the Internet and shipping revenue, net of estimated returns and promotional discounts and excluding sales taxes. The Company recognizes revenue when all of the following have occurred: persuasive evidence of an agreement with the customer exists, delivery has occurred or services have been rendered, the selling price is fixed or determinable and collectability of the selling price is reasonably assured. The Company evaluates whether it is appropriate to record the gross amount of product sales and related costs or the net amount earned. Revenue is recorded at the gross amount when the Company is the primary obligor, is subject to inventory and credit risk, has latitude in establishing price and product specification, or has most of these indicators. When the Company is not primarily obligated and has no latitude in establishing the price, revenue will be recorded at the net amount earned.

The Company requires payment at the point of sale. Amounts received before the customer assumes the risk of loss are not recorded as revenue. For sales to customers, the Company recognizes revenue when delivery has occurred, as this is when the risk of loss transfers, which is typically one to three days after shipment. The Company generally offers a return policy of 30 days and provides an allowance for sales returns during the period in which the sales are made. At January 3, 2016 and January 4, 2015, the reserve for sales returns was \$1.3 million and \$1.0 million, respectively, and was recorded as an accrued liability. Sales and cost of sales reported in the consolidated statements of operations are reduced to reflect estimated returns. The estimates are based on the Company's historical product return rates and current economic conditions.

The Company currently has a lifetime diamond upgrade program on all certified diamonds purchased since the Company's inception. This is accounted for as a guarantee and at January 3, 2016 and January 4, 2015, the estimated fair value of the guarantee was inconsequential.

The Company generally does not extend credit to customers, except through third party credit cards. The majority of sales are through credit cards, and trade accounts receivable are composed primarily of amounts due from financial institutions related to credit card sales. The Company does not maintain an allowance for doubtful accounts because payment is typically received within two business days after the sale is complete.

Shipping and Handling Costs

The Company's shipping and handling costs primarily include payments to third-parties for shipping merchandise to the Company's customers. Shipping and handling costs of approximately \$4.6 million, \$4.8 million and \$4.6 million in the fiscal years ended January 3, 2016, January 4, 2015 and December 29, 2013, respectively, were included in cost of sales.

Cost of Sales

Cost of sales consists of the cost of merchandise sold to customers, inbound and outbound shipping costs, insurance on shipments, the costs incurred to set diamonds into ring, earring and pendant settings, including labor and related facility costs, and depreciation on assembly related property, plant and equipment.

Selling, General and Administrative Expenses



Selling, general and administrative expenses consist primarily of payroll and related benefit costs for the Company's employees, marketing costs, stock-based compensation and credit card fees. These expenses also include certain facility-related costs, and fulfillment, customer service, technology and depreciation expenses, as well as professional fees and other general corporate expenses.

Fulfillment costs include costs incurred in operating and staffing the fulfillment center, including costs attributable to receiving, inspecting and warehousing inventories and picking, packaging and preparing customers' orders for shipment. Fulfillment costs in the years ended January 3, 2016, January 4, 2015 and December 29, 2013 were approximately \$2.8 million, \$3.3 million and \$3.6 million, respectively.

Table of Contents

BLUE NILE, INC

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

### Marketing

Marketing costs are expensed as incurred. Costs associated with web portal advertising contracts are amortized over the period such advertising is expected to be used. Costs of advertising associated with radio, print and other media are expensed when such services are used. Marketing expense for the fiscal years ended January 3, 2016, January 4, 2015 and December 29, 2013 was approximately \$27.1 million, \$25.0 million and \$24.3 million, respectively.

### Stock-Based Compensation

The Company measures compensation cost for all stock options and RSUs granted based on fair value on the measurement date, which is typically the grant date. The fair value of each stock option granted is estimated on the grant date using the Black-Scholes-Merton option valuation model. The fair value of each RSU is based on the fair market value of the Company's common stock on the date of the grant. Stock-based compensation expense is recognized on a straight-line basis over the requisite service period for each stock option or RSU grant expected to vest with forfeitures estimated at the date of grant based on the Company's historical experience and future expectations.

### Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update No. 2014-09 ("ASU 2014-09"), "Revenue from Contracts with Customers (Topic 606)" which amends the existing accounting standards for revenue recognition. ASU 2014-09 is based on the principle that revenue should be recognized to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The new revenue standard may be applied retrospectively to each prior period presented or retrospectively with the cumulative effect recognized as of the date of adoption. In August 2015, the FASB issued ASU No. 2015-14, "Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date", which delays the effective date by one year effective on the first quarter of 2018, with the option to adopt in the first quarter of 2017. The Company is currently evaluating the effect that the updated standard will have on its consolidated financial statements as well as the expected adoption method and related disclosures.

In July 2015, the FASB issued guidance on the subsequent measurement of inventory, which changes the measurement from lower of cost or market to lower of cost and net realizable value. The guidance will require prospective application at the beginning of the Company's first quarter of fiscal year 2017, but permits adoption in an earlier period. The Company is currently evaluating the impact this guidance will have on its consolidated financial statements and the timing of adoption.

In November 2015, the FASB issued Accounting Standards Update No. 2015-17 ("ASU 2015-17"), "Income Taxes (Topic 740): Balance Sheet Classification of Deferred Taxes" which simplifies the presentation of deferred income taxes by requiring deferred tax assets and liabilities to be classified as noncurrent on the balance sheet. ASU 2015-17 is effective for periods beginning on January 1, 2017 and may be applied prospectively or retrospectively. Early adoption is permitted. The Company early-adopted the guidance in ASU 2015-17 and has classified its deferred income tax assets as noncurrent in the accompanying consolidated balance sheet as of January 3, 2016. The Company applied this updated guidance retrospectively. The impact of early adopting ASU 2015-17 resulted in a reclassification of our current deferred income tax asset to the non-current deferred income tax asset in the amount of \$1.1 million, in

our previously presented consolidated balance sheet as of January 4, 2015.

In January 2016, the FASB issued Accounting Standards Update No. 2016-01 "Financial Instruments - Overall ("ASU 2016-01"), "Recognition and Measurement of Financial Assets and Financial Liabilities" which amends various aspects of recognition, measurement, presentation and disclosure of financial instruments. With respect to our consolidated financial statements the most significant impact of this update will be revising certain classification and measurement of our investments in equity securities accounted for under the cost method. This update will require prospective application at the beginning of the Company's first quarter of fiscal year 2018. For certain provisions, early adoption is permitted. The Company is currently evaluating the impact this update will have on its consolidated financial statements and related disclosures.

In February 2016, the FASB issued Accounting Standards Update No. 2016-02 "Leases (Topic 842)", which increases transparency and comparability among companies accounting for lease transactions. The most significant change of this update will require the recognition of lease assets and liabilities on the balance sheet for operating lease arrangements with lease terms greater than 12 months for lessees. This update will require a modified retrospective application which includes a number of optional practical expedients related to the identification and classification of leases commenced before the effective date. This

Table of Contents

BLUE NILE, INC

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

update will become effective beginning the first quarter of the Company's fiscal year 2019. Early application is permitted. The Company is currently evaluating the impact this update will have on its consolidated financial statements and the timing of adoption.

Note 2. Inventories

Inventories consist of the following (in thousands):

	January 3, 2016	January 4, 2015
Loose diamonds	\$12,420	\$6,439
Fine jewelry and other	33,956	35,229
Total	\$46,376	\$41,668

Note 3. Property and Equipment

Property and equipment consist of the following (in thousands):

January 3,  
2016