STAMPS.COM INC
Form 10-Q
August 09, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2006

OR

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

For the transition period from ____________ to ____________

Commission file number: 000-26427

Stamps.com Inc.
(Exact name of registrant as specified in its charter)

Delaware	**77-0454966**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

12959 Coral Tree Place
Los Angeles, California 90066
(Address of Principal Executive Offices)

Registrant's telephone number, including area code: **(310) 482-5800**

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of “accelerated filer and large accelerated filer” in Rule 12b-2 of the Exchange Act. (Check one):
Large accelerated filer ¨ Accelerated filer þ Non-accelerated filer ¨

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

As of July 31, 2006, there were approximately 23,996,899 shares of the Registrant’s Common Stock issued and outstanding.

STAMPS.COM INC.

FORM 10-Q QUARTERLY REPORT FOR THE QUARTER ENDED JUNE 30, 2006

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PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

STAMPS.COM INC.
BALANCE SHEETS
(In thousands, except per share data)

	June 30, 2006 (unaudited)	December 31, 2005
Assets		
Current assets:		
Cash and cash equivalents	$ 18,838	$ 20,768
Restricted cash	554	554
Short-term investments	15,557	19,450
Trade accounts receivable, net	2,335	2,131
Other accounts receivable	257	628
Other current assets	2,209	1,278
Total current assets	39,750	44,809
Property and equipment, net	5,384	4,492
Intangible assets, net	3,116	3,666
Long-term investments	82,456	63,207
Other assets	3,596	2,280
Total assets	$ 134,302	$ 118,454
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable and accrued expenses	$ 8,920	$ 8,514
Total current liabilities	8,920	8,514
Commitments and contingencies		
Stockholders' equity:		
Common stock, $.001 par value		
Authorized shares 47,500 in 2006 and 2005		
Issued shares of 23,963 in 2006 and 23,372 in 2005		
Outstanding shares of 23,654 in 2006 and 23,063 in 2005	47	46
Additional paid-in capital	616,357	607,869
Accumulated deficit	(486,166)	(493,683)
Treasury Stock, at cost, 309 shares in 2006 and 2005	(3,737)	(3,737)
Accumulated other comprehensive loss	(1,119)	(555)
Total stockholders' equity	125,382	109,940
Total liabilities and stockholders' equity	$ 134,302	$ 118,454

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

STAMPS.COM INC.
STATEMENTS OF INCOME
(In thousands, except per share data)
(Unaudited)

	Three Months ended June 30,		Six Months ended June 30,	
	2006	**2005**	**2006**	**2005**
Revenues:				
Service	$ 13,628	$ 10,439	$ 27,085	$ 19,539
PhotoStamps	3,747	1,159	7,607	1,159
Product	1,980	1,826	4,373	3,710
Other	805	799	1,637	1,612
Total revenues	20,160	14,223	40,702	26,020
Cost of revenues:				
Service	2,353	2,543	4,940	5,028
PhotoStamps	2,378	764	4,799	764
Product	628	545	1,381	1,071
Other	169	131	339	264
Total cost of revenues	5,528	3,983	11,459	7,127
Gross profit	14,632	10,240	29,243	18,893
Operating expenses:				
Sales and marketing	6,446	4,439	13,270	8,139
Research and development	2,159	1,571	4,498	3,076
General and administrative	3,213	2,512	6,371	4,897
Total operating expenses	11,818	8,522	24,139	16,112
Income from operations	2,814	1,718	5,104	2,781
Other income:				
Interest income	1,399	446	2,478	997
Other income	—	—	—	64
Total other income	1,399	446	2,478	1,061
Income before income taxes	4,213	2,164	7,582	3,842
Provision for income taxes Basic	53	43	65	80
Net income	$ 4,160	$ 2,121	$ 7,517	$ 3,762
Net income per share (see Note 3):				
Basic Basic	$ 0.18	$ 0.09	$ 0.32	$ 0.17
Diluted	$ 0.17	$ 0.09	$ 0.31	$ 0.16
Weighted average shares outstanding				
Basic Basic	23,601	22,689	23,435	22,602
Diluted	24,561	23,819	24,474	23,631

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

STAMPS.COM INC.
STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	Six Months ended June 31, 2006	Six Months ended June 31, 2005
Operating activities:		
Net income	$ 7,517	$ 3,762
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,408	1,488
Stock-based compensation expense	1,491	—
Changes in operating assets and liabilities:		
Trade accounts receivable	(204)	(355)
Other accounts receivable	371	170
Other assets	(1,316)	(705)
Prepaid expenses	(931)	(662)
Accounts payable and accrued expenses	405	1,018
Net cash provided by operating activities	8,741	4,716
Investing activities:		
Sale of short-term investments	22,146	4,877
Purchase of short-term investments	(18,211)	(6,373)
Sale of long-term investments	12,180	37,197
Purchase of long-term investments	(32,034)	(40,394)
Acquisition of property and equipment	(1,750)	(1,884)
Net cash used in investing activities	(17,669)	(6,577)
Financing activities:		
Proceeds from exercise of stock options	6,760	2,182
Issuance of common stock under ESPP	238	160
Net cash provided by financing activities	6,998	2,342
Net (decrease) increase in cash and cash equivalents	(1,930)	481
Cash and cash equivalents at beginning of period	20,768	11,198
Cash and cash equivalents at end of period	$ 18,838	$ 11,679

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

STAMPS.COM
NOTES TO FINANCIAL STATEMENTS
(ALL INFORMATION WITH RESPECT TO JUNE 30, 2006 AND 2005 IS UNAUDITED)

1. Summary of Significant Accounting Policies

Basis of Presentation

The financial statements included herein have been prepared by Stamps.com Inc. (Stamps.com or Company) without audit pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Certain information and footnote disclosures normally included in financial statements prepared in accordance with US generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations. The Company believes that the disclosures are adequate to make the information presented not misleading. It is suggested that these financial statements be read in conjunction with the financial statements and the notes thereto included in the Company's latest annual report on Form 10-K.

In the opinion of the Company, these unaudited financial statements contain all adjustments (consisting of normal recurring adjustments) necessary to present fairly the financial position of the Company as of June 30, 2006, the results of its operations for the three months and six months ended June 30, 2006 and 2005, and its cash flows for the six months ended June 30, 2006 and 2005.

Use of Estimates and Risk Management

The preparation of financial statements in conformity with US generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and the accompanying notes. Actual results could differ from those estimates and such differences may be material to the financial statements. Examples include estimates of loss contingencies, promotional coupon redemptions and estimates regarding the useful lives of patents and other amortizable intangibles.

The Company is involved in various litigation matters as a claimant and a defendant. The Company records any amounts recovered in these matters when received. The Company records liabilities for claims against it when the loss is probable and estimable. Amounts recorded are based on reviews by outside counsel, in-house counsel and management. Actual results could differ from estimates.

Income Taxes

The provision for income taxes consists solely of alternative minimum federal and state taxes. The Company's effective income tax rate differs from the statutory income tax rate primarily as a result of the establishment of a valuation allowance for the future benefits to be received from the deferred tax assets including net operating loss carryforwards and research tax credits carryforwards as well as the use of net operating losses to offset taxable income. The Company recorded a tax provision subject to the corporate alternative minimum federal and state taxes of approximately $53,000 and $43,000 for the three months ended June 30, 2006 and 2005, respectively, and $65,000 and $80,000 for the six months ended June 30, 2006 and 2005, respectively.

2. Legal Proceedings

Please refer to "Part II - Other Information - Item 1 - Legal Proceedings" of this report for a discussion of legal proceedings.

3. Net Income per Share

Net income per share represents net income attributable to common stockholders divided by the weighted average number of common shares outstanding during a reported period. The diluted net income per share reflects the potential dilution that could occur if securities or other contracts to issue common stock, including convertible preferred stock and stock options and warrants (commonly and hereafter referred to as "common stock equivalents"), were exercised or converted into common stock. Diluted net income per share is calculated by dividing net income during a reported period by the sum of the weighted average number of common shares outstanding plus common stock equivalents for the period. Basic and diluted income per share for the three and six months ended June 30, 2005 were calculated based on net income not including stock based compensation expense as required by Statement of Financial Accounting Standards No. 123 (revised 2004), "Share-Based Payment" (SFAS 123R). The Company adopted SFAS 123R on January 1, 2006 using the modified prospective transition method which does not require the Company's prior period financial statements to be restated. Therefore, prior period earnings per share have not been restated as allowed by SFAS 123R. The following table reconciles share amounts utilized to calculate basic and diluted net income per share (in thousands, except per share data):

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STAMPS.COM
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(ALL INFORMATION WITH RESPECT TO JUNE 30, 2006 AND 2005 IS UNAUDITED)

	Three Months Ended June 30,				Six Months Ended June 30,			
	2006		2005		2006		2005	
Net income	$	4,160	$	2,121	$	7,517	$	3,762
Basic - weighted average common shares		23,601		22,689		23,435		22,602
Diluted effect of common stock equivalents		960		1,130		1,039		1,029
Diluted - weighted average common shares		24,561		23,819		24,474		23,631
Earnings per share:								
Basic	$	0.18	$	0.09	$	0.32	$	0.17
Diluted	$	0.17	$	0.09	$	0.31	$	0.16

The calculation of dilutive shares excludes the effect of the following options that are considered anti-dilutive (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Anti-dilutive stock options shares	286	251	234	759

4. Stock-Based Employee Compensation

Effective January 1, 2006, the Company adopted the Statement of Financial Accounting Standards No. 123 (revised 2004), “Share-Based Payment” (SFAS 123R), and related SEC rules included in Staff Accounting Bulletin No. 107 (SAB 107), which require the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors including employee stock options and employee stock purchases related to the Employee Stock Purchase Plan (employee stock purchases) based on estimated fair values.

The Company adopted SFAS 123R using the modified prospective transition method, which requires the application of the accounting standard as of January 1, 2006, the first day of the Company’s fiscal year 2006. The Company’s Financial Statements as of and for the three and six months ended June 30, 2006 reflect the impact of SFAS 123R. In accordance with the modified prospective transition method, the Company’s Financial Statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS 123R. Stock-based compensation expense recognized under SFAS 123R was $696,000 for the three months ended June 30, 2006 and $1.5 million for the six months ended June 30, 2006, which consist of stock-based compensation expense related to employee and director stock options and employee stock purchases of $696,000 and $0, respectively, for the three months ended June 30, 2006, and $992,000 and $499,000, respectively, for the six months ended June 30, 2006.

SFAS 123R requires companies to estimate the fair value of share-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service periods in the Company’s Statement of Income. Prior to the adoption of SFAS 123R, the Company accounted for stock-based awards to employees and directors using the intrinsic value method in accordance with APB 25 as allowed under Statement of Financial Accounting Standards No. 123, “Accounting for

Stock-Based Compensation” (SFAS 123). Under the intrinsic value method, no stock-based compensation expense had been recognized in the Company’s Statement of Income prior to January 1, 2006 because the exercise price of the Company’s stock options granted to employees and directors was equal to or greater than the fair market value of the underlying stock at the date of grant.

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The following table illustrates the reported and pro forma effect on net income and earnings per share if the Company had elected to apply the fair value recognition provisions of SFAS 123 for the three and six months ended June 30, 2005 (in thousands, except per share data):

	Three Months Ended June 30, 2005		Six Months Ended June 30, 2005	
Net income as reported	$	2,121	$	3,762
Add: Stock price based employee expense included in net loss		—		—
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects		(274)		(602)
Net income pro forma	$	1,847	$	3,160
Basic net income per common share-as reported	$	0.09	$	0.17
Diluted net income per common share-as reported	$	0.09	$	0.16
Basic net income per common share-pro forma	$	0.08	$	0.14
Diluted net income per common share-pro forma	$	0.08	$	0.13

Stock-based compensation expense recognized during the period is based on the value of the portion of share-based payment awards that is ultimately expected to vest during the period. Stock-based compensation expense recognized in the Company’s Statement of Income for the three and six months ended June 30, 2006 included 1) compensation expense for share-based payment awards granted prior to, but not yet vested as of January 1, 2006 based on the grant date fair value estimated in accordance with the pro forma provisions of SFAS 123 and 2) compensation expense for the share-based payment awards granted subsequent to December 31, 2005 based on the grant date fair value estimated in accordance with the provisions of SFAS 123R.

Compensation expense recognized for all employee stock options awards granted is recognized using the straight-line single method over their respective vesting periods of three or four years. As stock-based compensation expense recognized in the Statement of Income for the three and six months ended June 30, 2006 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS 123R requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. In the Company’s pro forma information required under SFAS 123 for the periods prior to fiscal 2006, the Company accounted for forfeitures as they occurred.

SFAS 123R requires the cash flow resulting from tax benefits resulting from tax deduction in excess of the compensation cost recognized for those options (excess tax benefits) to be classified as financing cash flows. Prior to fiscal 2005 the Company had a history of net operating losses and because it is uncertain as to when and if it may realize its deferred tax assets, the Company has placed a valuation allowance against its otherwise recognizable deferred tax asset. Therefore, there are no excess tax benefits recorded in the financing cash inflow that would have been classified as an operating cash inflow if the Company had not adopted SFAS 123R. During the three and six months ended June 30, 2006, the Company received $1.7 million and $7.0 million, respectively, in cash from stock options exercised and from shares issued through the Employee Stock Purchase Program.

Upon adoption of SFAS 123R the Company continued to use the Black-Scholes option valuation model, which requires management to make certain assumptions for estimating the fair value of employee stock options granted at the date of the grant. The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock price volatility. Because the Company's employee stock options have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimates, in management's opinion the existing models may not necessarily provide a reliable single measure of the fair value of the Company's employee stock options. Although the fair value of employee stock options is determined in accordance with SFAS 123R using an option valuation model, that value may not be indicative of the fair value observed in a willing buyer/willing seller market transaction.

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For options granted, the Company's assumption of expected volatility for valuing options using the Black-Scholes model was based on the historical volatility of the Company's stock price for the period January 1, 2002 through the date of option grant because management believes the historical volatility since January 1, 2002 is more representative of prospective volatility. The risk-free interest rate is based on U.S. Treasury zero-coupon issues with a remaining term equal to the expected life assumed at the date of grant.

The following are the weighted average assumptions used in the Black-Scholes valuation model for the periods indicated:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	**2005**	**2006**	**2005**
Expected dividend yield	—	—	—	—
Risk-free interest rate	5.0%	4.01%	4.78%	3.84%
Expected volatility	49%	48%	49%	48%
Expected life (in years)	5	5	5	5
Expected forfeiture rate	16%	—	14%	—

The following table summarizes stock option activity related to the Company's plan for the six months ended June 30, 2006:

	Number of Stock Options (in thousands)	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (in years)	Aggregate Intrinsic Value (in thousands)
Outstanding at December 31, 2005	2,608	$ 15.03		
Granted	202	31.89		
Exercised	(567)	11.97		
Forfeited or expired	(33)	25.26		
Balance at June 30, 2006	2,210	16.45	6.5	$ 23,096
Exercisable at June 30, 2006	1,754	15.92	6.2	$ 20,883

The weighted average grant date fair value of options granted during the six months ended June 30, 2006 and 2005 was $15.51 and $7.46, respectively. The total intrinsic value of options exercised during the six months ended June 30, 2006 and 2005 was $8,633,927 and $3,457,428, respectively.

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(ALL INFORMATION WITH RESPECT TO JUNE 30, 2006 AND 2005 IS UNAUDITED)

The following table summarizes the status of the Company's nonvested shares as of June 30, 2006:

	Number of Stock Options (in thousands)	Weighted Average Grant Date Fair Value
Nonvested at December 31, 2005	416	$ 7.37
Granted	202	15.51
Vested	(81)	6.26
Forfeited	(33)	14.11
Nonvested at June 30, 2006	504	10.91

As of June 30, 2006, there was approximately $4.7 million of total unrecognized compensation cost related to nonvested share-based compensation arrangements, which is expected to be recognized over a weighted-average period of 7.8 years.

5. Goodwill and Intangible Assets

The Company wrote off all of its goodwill in the first quarter of 2001 due to impairment. The Company's other intangible assets, which consist of patents, trademarks and other intellectual property with a gross carrying value of $8.9 million as of June 30, 2006 and December 31, 2005 and accumulated amortization of approximately $5.8 million and $5.2 million as of June 30, 2006 and December 31, 2005, respectively, continue to be amortized over their expected useful lives ranging from 4 to 17 years with a remaining weighted average amortization period of 1.6 years.

Aggregate amortization expense on intangible assets was approximately $275,000 for the three months ended June 30, 2006 and 2005, respectively and $550,000 for the six months ended June 30, 2006 and 2005, respectively.

6. Comprehensive Income

The following table provides the data required to calculate comprehensive income (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Net income	$ 4,160	$ 2,121	$ 7,517	$ 3,762
Unrealized income (loss) on investments	(423)	393	(564)	68
Comprehensive income	$ 3,737	$ 2,514	$ 6,953	$ 3,830

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This Quarterly Report on Form 10-Q contains "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. These statements relate to expectations concerning matters that are not historical facts. Words such as "projects," "believes," "anticipates," "estimates," "plans," "expects," "intends," and similar words and expressions are intended to identify forward-looking statements. Although Stamps.com believes that such forward-looking statements are reasonable, we cannot assure you that such expectations will prove to be correct. Factors that could cause actual results to differ materially from such expectations are disclosed herein. All forward-looking statements attributable to Stamps.com are expressly qualified in their entirety by such language. Stamps.com does not undertake any obligation to update any forward-looking statements. You are also urged to carefully review and consider the various disclosures we have made which describe certain factors which affect our business. The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our financial statements and the related notes thereto.

Stamps.com, NetStamps, PhotoStamps, Hidden Postage, Stamps.com Internet postage and the Stamps.com logo are our trademarks. This report also includes trademarks of entities other than Stamps.com.

Overview

Stamps.comÒ (the "Company" or "Stamps.com") is the leading provider of Internet-based postage solutions. Our core service allows customers to buy and print United States Postal Service (“US Postal Service” or “USPS”) approved postage using any PC, an ordinary inkjet or laser printer, and an Internet connection. Customers use our service to mail and ship a variety of mail pieces including postcards, envelopes, flats and packages, and using a wide range of USPS mail classes including First Class Mail®, Priority Mail®, Express Mail®, Media Mail®, Parcel Post®, and others. Our customers include home businesses, small businesses, corporations and individuals. In 1999, we became the first ever USPS-licensed vendor to offer PC Postage® in a software-only business model. On August 10, 2004, we publicly launched a market test of PhotoStamps®, a new form of postage that allows consumers to turn digital photos, designs or images into valid US postage. We completed the first market test on September 30, 2004, launched a second market test of PhotoStamps on May 17, 2005, and subsequently a third market test on May 17, 2006. This third phase of the market test has an initial authorization period of one year, through May 16, 2007, and includes an option for the US Postal Service to extend the test for a second year to May 16, 2008. Throughout this document and in general when we refer to our core business, we mean the PC Postage business which excludes only the PhotoStamps business.

Stamps.com Inc. was founded in September 1996 to investigate the feasibility of entering into the US Postal Service’s Information-Based Indicia Program and to initiate the certification process for our PC Postage service. In January 1998, we were incorporated in Delaware as StampMaster, Inc. and we changed our name to Stamps.com Inc. in December 1998. We completed our initial public offering in June 1999, and our common stock is listed on the Nasdaq stock market under the symbol “STMP.”

Our principal executive offices are located at 12959 Coral Tree Place, Los Angeles, California, 90066, and our telephone number is (310) 482-5800.

Our Services and Products

We offer the following products and services to our customers:

PC Postage Service

Our USPS-approved PC Postage service enables users to print information-based indicia, or electronic stamps, directly onto envelopes, plain paper, or labels using ordinary laser or inkjet printers. Our service currently supports USPS classes including First-Class MailÒ, Priority MailÒ, Express MailÒ, Parcel Post®, Media MailÔ and Bound Printed Matter. Customers can also add USPS Special Services such as Delivery Confirmation™, Signature Confirmation™, Registered Mail, Certified Mail, Insured Mail, Return Receipt, Collect on Delivery and Restricted Delivery to their mail pieces. Our service requires only a standard PC, printer and Internet connection. Our free software can be downloaded from the Internet or installed from a CD-ROM. After installing the software and completing a registration process, customers can purchase and print postage 24 hours a day, seven days a week. When a customer purchases postage for use through our service, the customer pays face value, and the funds are transferred directly from the customer's account to the US Postal Service's account. The majority of new customers currently signing up for our service pay a monthly convenience fee of $15.99. Our current customer mix includes monthly convenience fees ranging from $4.49 to $24.99 or more based on individual pricing and promotions.

Stamps.com offers its customers three primary ways to print PC Postage. First, our NetStamps® feature enables customers to print postage for any value or any class of mail or package on NetStamps labels. After they are printed, NetStamps can be used just like regular stamps. Second, our shipping feature tab allows customers to print postage for packages on plain 8.5” x 11” paper or on special labels, and to add electronic Delivery or Signature Confirmation at discounted prices. Third, our mailing feature tab is typically used to print the postage and address directly on envelopes or on other types of mail or labels, in a single-step process that saves time and provides a professional look. Our PC Postage services also incorporate address verification technology that verifies each destination address for mail sent using our service against a database of all known addresses in the U.S. In addition, our PC Postage services have been designed to integrate into common small business and productivity software applications such as word processing, contact and address management, and accounting and financial applications.

PhotoStamps®

On May 17, 2005, we publicly launched our second market test of PhotoStamps, a patented form of postage that allows consumers to turn digital photos, designs or images into valid U.S. postage. PhotoStamps is used as regular postage to send letters, postcards or packages. On May 17, 2006 we launched a new PhotoStamps feature that allows businesses to use PhotoStamps to create awareness for their products or services, to build their brand, or for other commercial applications. Customers of PhotoStamps upload a digital photograph or image file, customize the look and feel by choosing one of ten different border colors to compliment the photos, select the value of postage, and place the order online. Each sheet includes 20 individual PhotoStamps, and orders arrive via US Mail in a few business days. In addition to the sheet format, PhotoStamps are also available in a roll form factor for use in higher volume applications. Individual rolls are available in custom lengths ranging from 250 to 10,000 PhotoStamps, and in denominations ranging from $0.24 for postcard rates to $4.05 for one pound packages. The product is available via our website at www.photostamps.com. PhotoStamps is currently offered for $17.99 for a single sheet of $.39 value PhotoStamps. Pricing may vary depending upon the postage denomination, volume of PhotoStamps purchased and promotions.

Since the beginning of the second market test, PhotoStamps has been prominently featured in the national media. For example, in its December 19, 2005 issue, BusinessWeek named PhotoStamps one of its Best Products for 2005. From May 2005 to June 2006, we shipped approximately 950,000 PhotoStamps sheets, or approximately 19 million individual PhotoStamps. We are currently authorized to sell PhotoStamps under the third phase market test that began May 17, 2006 and continues through May 16, 2007, with an option for the US Postal Service to extend the test for a second year to May 16, 2008.

Supplies Store

With the launch of NetStamps in July 2002, we began selling NetStamps labels directly to our customers via our Supplies Store (previously also referred to as our “Online Store”) which is accessible to our customers from within our PC Postage software. Our Supplies Store has since expanded to sell themed NetStamps labels, shipping labels, other mailing labels, dedicated postage printers, OEM and private label inkjet and laser toner cartridges, scales, and other mailing and shipping-focused office supplies. We plan to continue to increase the breadth of products offered in our Supplies Store in order to provide a more complete service to our customers, and with the goal of increasing our revenue.

Branded Insurance

We offer Stamps.com branded insurance to our users so that they may insure their mail or packages in a fully integrated, online process that eliminates any trips to the Post Office or the need to complete any special forms (we also offer official US Postal Service insurance alongside our branded insurance product). Our Stamps.com branded insurance is currently offered at a ten percent discount to the rates offered by the U.S. Postal Service. As insurance is purchased by our customers, we pass along the necessary information to the insurance provider. Our branded insurance program is currently provided in partnership with the broker Parcel Insurance Plan and is underwritten by Fireman's Fund.

Recent Developments

On July 25, 2006, we released a new software platform that allows us to provide a single web presentation and e-commerce system for all Stamps.com products and services. The new system will, among other things, provide enhanced cross-selling and up-selling tools, automated marketing, and item cataloging and display. This new system will also serve as the foundation for our future e-commerce initiatives.

On July 25, 2006, we also announced plans to release version 6.0 of our PC Postage client software into beta. This updated client software is built to take full advantage of our new software platform. Version 6.0 also includes new features such as an international shipping capability with fully integrated customs forms. We expect to move version 6.0 into general release during the third quarter of 2006.

Critical Accounting Policies

General. The discussion and analysis of our financial condition and results of operations are based on our Company's financial statements which have been prepared in accordance with U.S. generally accepted accounting principles. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an on-going basis, we evaluate our estimates, including those related to patents, contingencies and litigation. We base our estimates on historical experience and on various other assumptions that we believe are reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our financial statements.

Revenue Recognition. We recognize revenue from product sales or services rendered, as well as from licensing the use of our software and intellectual property, when the following four revenue recognition criteria are met: persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the selling price is fixed or determinable, and collectibility is reasonably assured.

Service revenue is based on monthly convenience fees and is recognized in the period that services are provided. Product sales, net of return allowances, are recorded when the products are shipped and title passes to customers. Items, including PhotoStamps, sold to customers are made pursuant to a sales contract that provides for transfer of both title and risk of loss upon our delivery to the carrier. Return allowances, which reduce product revenue by our best estimate of expected product returns, are estimated using historical experience. Licensing revenue is recognized ratably over the contract period. Commissions from the advertising or sale of products by a third party vendor to our customer base are recognized when the revenue is earned and collection is deemed probable.

Customers who purchase postage for use through our NetStamps, shipping label or mailing features, pay face value, and the funds are transferred directly from the customers to the US Postal Service. No revenue is recognized for this postage as it is purchased by our customers directly from the US Postal Service.

PhotoStamps revenue includes the price of postage and is made pursuant to a sales contract that provides for transfer of both title and risk of loss upon our delivery to the carrier.

On a limited basis, we allow third parties to offer products and promotions to the Stamps.com customer base. These arrangements generally provide payment in the form of a flat fee or revenue sharing arrangements where we receive payment upon customers accessing third party products and services. Total revenue from such advertising arrangements is currently immaterial.

We provide our customers with the opportunity to purchase parcel insurance directly through the Stamps.com software. Insurance revenue represents the gross amount charged to the customer for purchasing insurance and the related cost represents the amount paid to the insurance broker, Parcel Insurance Plan. We recognize revenue on insurance purchases upon the ship date of the insured package.

Licensing revenue for the use of our software and intellectual property is recognized when the following four revenue recognition criteria are met: persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the selling price is fixed or determinable, and collectibility is reasonably assured.

Advertising Costs. We expense the costs of producing advertisements as incurred, and expense the costs of communicating and placing the advertising in the period in which the advertising space or airtime is used.

Internet Advertising. We recognize expense based on the specifics of the individual agreements. Under partner and affiliate agreements, third parties refer prospects to our web site and we pay the third parties when the customer completes the customer registration process, completes the first purchase or in some cases, upon the first successful billing of a customer. We record these expenses on a monthly basis as prospects are successfully converted to customers.

Intangibles. We make an assessment of the estimated useful lives of our patents and other amortizable intangibles. These estimates are made using various assumptions that are subjective in nature and could change as economic and competitive conditions change. If events were to occur that would cause our assumptions to change, the amounts recorded as amortization would be adjusted.

Contingencies and Litigation. We are involved in various litigation matters as a claimant and as a defendant. We record any amounts recovered in these matters when collection is certain. We record liabilities for claims against us when the losses are probable and estimatable. Any amounts recorded would be based on reviews by outside counsel, in-house counsel and management. Actual results may differ from estimates.

Promotional Expense. New core service customers are generally offered promotional items that are redeemed using coupons that are qualified for redemption after a customer is successfully billed beyond an initial trial period. This includes free postage and a free digital scale and is expensed in the period in which a customer qualifies using estimated redemption rates based on historical data. Promotional expense which is included in cost of service is incurred as customers qualify and thereby may not correlate directly with changes in revenue as the revenue associated with the acquired customer is earned over the customer's lifetime.

Section 382 Update

Under Internal Revenue Code Section 382, a change in ownership can occur whenever there is a shift in ownership by more than 50 percentage points by one or more five-percent shareholders within a three-year period. When a change of ownership is triggered, our net operating loss ("NOL" or "NOLs") asset may be impaired. We estimate that, as of March 31, 2006 we are approximately at 25% compared with the 50% level that would trigger impairment of our NOL asset. As part of our ongoing program to preserve future use of our NOL assets, *Stamps.com requests that all of our current stockholders and prospective investors contact us prior to allowing their ownership interest to reach a five-percent level.*

Results of Operations

During the second quarter of 2006, we experienced continued revenue growth in our core PC Postage business and PhotoStamps sales continued to be strong despite the expected second quarter seasonal slowdown. Our total revenue during the second quarter of 2006 was $20.2 million, compared to $14.2 million during the comparable period in 2005. Total postage printed using our service during the second quarter of 2006 was up 22% compared to the second quarter of 2005. Gross customer core business acquisition was approximately 87,000 during the second quarter of 2006, up from approximately 66,000 during the second quarter of 2005.

The following table sets forth our results of operation as a percentage of total revenue for the periods indicated:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Total Revenues				
Service	68%	73%	66%	75%
PhotoStamps	19%	8%	19%	5%
Products	9%	13%	11%	14%
Other	4%	6%	4%	6%
Total revenues	100%	100%	100%	100%
Cost of revenues				
Service	11%	18%	12%	19%
PhotoStamps	12%	5%	12%	3%
Products	3%	4%	3%	4%
Other	1%	1%	1%	1%
Total cost of revenues	27%	28%	28%	27%
Gross profit	73%	72%	72%	73%
Operating expenses:				
Sales and marketing	32%	31%	32%	31%
Research and development	11%	11%	11%	12%
General and administrative				