

# DRUGSTORE COM INC

## FORM 10-Q (Quarterly Report)

Filed 08/08/08 for the Period Ending 06/29/08

Address	411 108TH AVE. NE SUITE 1400 BELLEVUE, WA 98004
Telephone	4253723200
CIK	0001086467
Symbol	DSCM
SIC Code	5912 - Drug Stores and Proprietary Stores
Industry	Retail (Drugs)
Sector	Services
Fiscal Year	12/31

---

---

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

---

**FORM 10-Q**

---

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

For the quarterly period ended June 29, 2008

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 000-26137

---

**drugstore.com, inc.**

(Exact name of registrant as specified in its charter)

---

**Delaware**  
(State or other jurisdiction  
of incorporation or organization)

**04-3416255**  
(IRS Employer  
Identification No.)

**411 108<sup>th</sup> Avenue NE, Suite 1400, Bellevue, Washington 98004**  
(Address of principal executive offices including zip code)

**(425) 372-3200**  
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  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.

Large accelerated filer

Accelerated filer

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

As of August 1, 2008, the registrant had 96,534,642 shares of common stock outstanding.

---

---

---

**Table of Contents**

**DRUGSTORE.COM, INC.**

**FORM 10-Q**

**For the three and six months ended June 29, 2008**

**INDEX**

	<u>Page</u>
<b>PART I. FINANCIAL INFORMATION</b>	<b>1</b>
Item 1. Financial Statements (unaudited):	1
Consolidated Statements of Operations	1
Consolidated Balance Sheets	2
Consolidated Statements of Cash Flows	3
Notes to Consolidated Financial Statements	4
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	12
Item 3. Quantitative and Qualitative Disclosures About Market Risk	23
Item 4. Controls and Procedures	23
<b>PART II. OTHER INFORMATION</b>	<b>24</b>
Item 1. Legal Proceedings	24
Item 1A. Risk Factors	24
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds	25
Item 3. Defaults Upon Senior Securities	25
Item 4. Submission of Matters to a Vote of Security Holders	25
Item 5. Other Information	25
Item 6. Exhibits	25
Signatures	26
Certifications	

PART I—FINANCIAL INFORMATION

Item 1. Financial Statements

**DRUGSTORE.COM, INC.**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
(in thousands, except share and per share data)  
(unaudited)

	Three Months Ended		Six Months Ended	
	June 29, 2008	July 1, 2007	June 29, 2008	July 1, 2007
Net sales	\$ 122,787	\$ 110,412	\$ 243,424	\$ 220,177
Costs and expenses:				
Cost of sales	93,308	85,317	185,031	170,379
Fulfillment and order processing	12,184	10,656	24,334	21,630
Marketing and sales	8,821	7,872	17,707	15,961
Technology and content	5,736	4,475	10,939	9,190
General and administrative	4,900	5,157	10,294	9,866
Amortization of intangible assets	210	306	455	750
Total costs and expenses	<u>125,159</u>	<u>113,783</u>	<u>248,760</u>	<u>227,776</u>
Operating loss	(2,372)	(3,371)	(5,336)	(7,599)
Interest income, net	100	356	379	806
Net loss	<u>\$ (2,272)</u>	<u>\$ (3,015)</u>	<u>\$ (4,957)</u>	<u>\$ (6,793)</u>
Basic and diluted net loss per share	<u>\$ (0.02)</u>	<u>\$ (0.03)</u>	<u>\$ (0.05)</u>	<u>\$ (0.07)</u>
Weighted average shares outstanding used to compute basic and diluted net loss per share	<u>96,478,573</u>	<u>95,006,512</u>	<u>96,435,655</u>	<u>94,753,321</u>

See accompanying notes to consolidated financial statements.

**Table of Contents**

**DRUGSTORE.COM, INC.**  
**CONSOLIDATED BALANCE SHEETS**  
(in thousands, except share data)

	<u>June 29,</u> <u>2008</u>	<u>December 30,</u> <u>2007</u>
<b>Assets</b>		
<b>Current assets:</b>		
Cash and cash equivalents	\$ 16,315	\$ 18,572
Marketable securities	18,931	17,677
Accounts receivable, net of allowances	41,706	38,063
Inventories	31,465	31,501
Prepaid marketing expenses	2,302	2,327
Other current assets	2,834	3,605
Total current assets	113,553	111,745
Fixed assets, net	29,147	25,501
Other intangible assets, net	4,143	4,598
Goodwill	32,202	32,202
Prepaid marketing expenses and other	222	1,362
Total assets	\$ 179,267	\$ 175,408
<b>Liabilities and Stockholders' Equity</b>		
<b>Current liabilities:</b>		
Accounts payable	\$ 62,892	\$ 61,414
Accrued compensation	4,913	4,657
Accrued marketing expenses	4,004	3,988
Other current liabilities	4,362	4,312
Current portion of long-term debt obligations	3,048	3,179
Total current liabilities	79,219	77,550
Long-term debt obligations, less current portion	4,016	1,221
Deferred income taxes	950	947
Other long-term liabilities	1,326	1,322
Commitments and contingencies		
<b>Stockholders' equity:</b>		
Preferred stock, \$.0001 par value, 10,000,000 shares authorized, no shares issued and outstanding	—	—
Common stock, \$.0001 par value, stated at amounts paid in: 250,000,000 shares authorized, 96,478,573 and 96,296,687 shares issued and outstanding	860,548	856,193
Accumulated other comprehensive income	17	27
Accumulated deficit	(766,809)	(761,852)
Total stockholders' equity	93,756	94,368
Total liabilities and stockholders' equity	\$ 179,267	\$ 175,408

See accompanying notes to consolidated financial statements.

**DRUGSTORE.COM, INC.**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(in thousands)  
(unaudited)

	<u>Three Months Ended</u>		<u>Six Months Ended</u>	
	<u>June 29, 2008</u>	<u>July 1, 2007</u>	<u>June 29, 2008</u>	<u>July 1, 2007</u>
<b>Operating Activities:</b>				
Net loss	\$ (2,272)	\$ (3,015)	\$ (4,957)	\$ (6,793)
Adjustments to reconcile net loss to net cash provided by operating activities:				
Depreciation	2,776	1,911	4,852	3,802
Amortization of marketing and sales agreements	572	573	1,145	1,145
Amortization of intangible assets	210	306	455	750
Stock-based compensation	1,848	2,536	3,932	4,967
Other	(9)	(6)	(15)	(6)
Changes in:				
Accounts receivable	(2,851)	748	(3,643)	426
Inventories	(1,438)	391	36	1,040
Prepaid marketing expenses and other current assets	595	343	796	(225)
Accounts payable, accrued expenses, and other liabilities	4,802	(690)	1,799	(2,514)
Net cash provided by operating activities	<u>4,233</u>	<u>3,097</u>	<u>4,400</u>	<u>2,592</u>
<b>Investing Activities:</b>				
Purchases of marketable securities	(20,560)	(11,955)	(35,344)	(19,101)
Sales and maturities of marketable securities	15,660	10,690	34,098	18,465
Purchases of fixed assets	(2,934)	(2,954)	(8,116)	(5,130)
Net cash used in investing activities	<u>(7,834)</u>	<u>(4,219)</u>	<u>(9,362)</u>	<u>(5,766)</u>
<b>Financing Activities:</b>				
Proceeds from exercise of stock options and employee stock purchase plan	—	1,270	423	1,933
Borrowings on line of credit	—	—	3,500	300
Principal payments on capital leases and term loan obligations	(732)	(718)	(1,218)	(1,395)
Net cash provided by (used in) financing activities	<u>(732)</u>	<u>552</u>	<u>2,705</u>	<u>838</u>
Net decrease in cash and cash equivalents	(4,333)	(570)	(2,257)	(2,336)
Cash and cash equivalents at beginning of period	20,648	11,627	18,572	13,393
Cash and cash equivalents at end of period	<u>\$ 16,315</u>	<u>\$ 11,057</u>	<u>\$ 16,315</u>	<u>\$ 11,057</u>
<b>Supplemental Cash Flow Information:</b>				
Equipment acquired in capital lease agreements	<u>\$ 290</u>	<u>\$ 4</u>	<u>\$ 382</u>	<u>\$ 282</u>
Cash paid during the period for interest	<u>\$ 172</u>	<u>\$ 134</u>	<u>\$ 291</u>	<u>\$ 252</u>

See accompanying notes to consolidated financial statements.

**DRUGSTORE.COM, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(unaudited)**

**1. Description of the Business**

drugstore.com, inc. (drugstore.com) is a leading online provider of health, beauty, vision, and pharmacy products. We offer health, beauty, sexual well-being, household, and other non-prescription products and prescription medications through our web store located at *www.drugstore.com*. We also offer prestige beauty products through our web store located at *www.beauty.com* (which is also accessible through the drugstore.com website); contact lenses through our wholly owned subsidiary Vision Direct Inc. (Vision Direct), through web stores located at *www.visiondirect.com*, *www.lensmart.com*, and *www.lensquest.com* (which are also accessible through the drugstore.com website); and customized nutritional supplement programs through our wholly owned subsidiary, Custom Nutrition Services, Inc. (CNS). Our products are also available toll-free by telephone at 1-800-DRUGSTORE and 1-800-VISIONDIRECT. Under the terms of an agreement with Rite Aid Corporation, or Rite Aid, customers are also able to order refill prescriptions for pickup at any Rite Aid store. We manage our business in four segments: over-the-counter (OTC), vision, mail-order pharmacy, and local pick-up pharmacy.

**2. Basis of Presentation and Principles of Consolidation**

We have prepared the accompanying consolidated financial statements in conformity with U.S. generally accepted accounting principles (GAAP) and the rules and regulations of the Securities and Exchange Commission for interim financial reporting. These consolidated financial statements are unaudited but, in our opinion, include all adjustments, consisting of normal recurring adjustments and accruals, necessary for a fair presentation of the consolidated balance sheets, statements of operations, and statements of cash flows for the periods presented. Operating results for the periods presented are not necessarily indicative of future results for the fiscal year ending December 28, 2008 or any other interim period, due to seasonal and other factors. We have derived the consolidated balance sheet as of December 30, 2007 from audited financial statements as of that date, but we have excluded certain information and footnotes required by GAAP for complete financial statements. You should read these consolidated financial statements in conjunction with the audited consolidated financial statements and accompanying notes included in our annual report on Form 10-K for the fiscal year ended December 30, 2007.

The accompanying consolidated financial statements include those of drugstore.com, inc. and our subsidiaries. We have eliminated all material intercompany transactions and balances.

We operate using a 52/53-week retail calendar year, with each of the fiscal quarters in a 52-week fiscal year representing a 13-week period. Fiscal years 2008 and 2007 are 52-week years.

**3. Significant Accounting Policies**

*Estimates and Assumptions*

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts of assets and liabilities, revenues and expenses, and disclosure of contingent assets and liabilities at the date of the financial statements. These estimates include, but are not limited to, revenue recognition, inventories, goodwill and intangible assets, stock-based compensation, deferred taxes, and commitments and contingencies. Actual results could differ from our estimates, and these differences could be material.

*Recent Accounting Pronouncements*

In May 2008, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 162, *Hierarchy of Generally Accepted Accounting Principles* (SFAS 162). This statement is intended to improve financial reporting by identifying a consistent framework, or hierarchy, for selecting accounting principles to be used in preparing financial statements of nongovernmental entities that are presented in conformity with GAAP. This statement will be effective 60 days following the U.S. Securities and Exchange Commission's approval of the Public Company Accounting Oversight Board amendment to AU Section 411, *The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles*. We are currently evaluating the potential impact, if any, of the adoption of SFAS 162 on our consolidated financial statements.

## Table of Contents

In April 2008, the FASB issued FASB Staff Position (FSP) No. SFAS 142-3, *Determination of the Useful Life of Intangible Assets* (FSP SFAS 142-3). FSP SFAS 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS No. 142, *Goodwill and Other Intangible Assets* (SFAS 142). The intent of FSP SFAS 142-3 is to improve the consistency between the useful life of a recognized intangible asset under SFAS 142 and the period of expected cash flows used to measure the fair value of the asset under SFAS No. 141R (revised 2007), *Business Combinations* (SFAS 141R) and other applicable accounting literature. FSP SFAS 142-3 is effective for financial statements issued for fiscal years beginning after December 15, 2008 and must be applied prospectively to intangible assets acquired after the effective date. We are currently evaluating the potential impact, if any, of FSP SFAS 142-3 on our consolidated financial statements.

In February 2007, the FASB issued SFAS 159, *The Fair Value Option for Financial Assets and Liabilities* (SFAS 159). SFAS 159 became effective as of the beginning of the first fiscal year beginning after November 15, 2007. SFAS 159 provides companies with an option to report selected financial assets and liabilities at fair value that are not currently required to be measured at fair value. Accordingly, companies would then be required to report unrealized gains and losses on these items in earnings at each subsequent reporting date. The objective is to improve financial reporting by providing companies with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently. SFAS 159 also establishes presentation and disclosure requirements designed to facilitate comparisons between companies that choose different measurement attributes for similar types of assets and liabilities. The adoption of SFAS 159 in our first fiscal quarter of 2008 did not have an impact on our consolidated financial statements. We did not elect the fair value measurement option under SFAS 159 for any of our financial assets or liabilities.

In December 2007, the FASB issued SFAS No. 141 (R), *Business Combinations*, and SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements*. SFAS No. 141 (R) requires an acquirer to measure the identifiable assets acquired, the liabilities assumed and any noncontrolling interest in the acquiree at their fair values on the acquisition date, with goodwill being the excess value over the net identifiable assets acquired. SFAS No. 160 clarifies that a noncontrolling interest in a subsidiary should be reported as equity in the consolidated financial statements. The calculation of earnings per share will continue to be based on income amounts attributable to the parent. SFAS No. 141 (R) and SFAS No. 160 are effective for financial statements issued for fiscal years beginning after December 15, 2008. Early adoption is prohibited. We do not anticipate that the adoption of SFAS No. 141 (R) or SFAS No. 160 will currently have any material impact on our consolidated financial statements but will have an impact on any future business combinations consummated beginning in 2009.

### *Adoption of FASB Statement No. 157*

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value under GAAP, and expands disclosures about fair value measurements. SFAS 157 emphasizes that fair value is a market-based measurement, not an entity-specific measurement, and states that a fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability. In February 2008, the FASB issued FASB Staff Position No. FAS 157-2, *Effective Date of FASB Statement No. 157* (SFAS 157-2), which amends SFAS 157 by delaying its effective date by one year for non-financial assets and non-financial liabilities, except for items that are recognized or disclosed as fair value in the financial statements on a recurring basis. Therefore, beginning on the first day of fiscal year 2008, this standard applies prospectively to fair value measurements of financial instruments and recurring fair value measurements of non-financial assets and non-financial liabilities. Beginning on the first day of fiscal year 2009, the standard will also apply to all other fair value measurements. We do not anticipate that the adoption of SFAS 157-2 will have a material impact on our consolidated financial statements.

We adopted SFAS 157 on December 31, 2007, the first day of our fiscal year 2008. SFAS 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (exit price). The standard outlines a valuation framework and creates a fair value hierarchy in order to increase consistency and comparability of fair value measurements and the related disclosures. Under GAAP, certain assets and liabilities must be measured at fair value, and SFAS 157 details the disclosures that are required for measured fair value. We have certain financial assets including money market funds and marketable securities that are measured at the new fair value standard. We currently do not have non-financial assets and non-financial liabilities that are required to be measured at fair value on a recurring basis. Our financial assets and liabilities are measured using inputs from the three levels of the fair value hierarchy. The three levels are as follows:

- Level 1     Inputs are unadjusted quoted prices in active markets for identical assets or liabilities that we have the ability to access at the measurement date.
- Level 2     Inputs include unadjusted quoted prices in active markets for similar assets or liabilities, or unadjusted quoted prices for identical or similar assets or liabilities in markets that are not active, or inputs other than quoted prices that are observable for the asset or liability.
- Level 3     Unobservable inputs for the asset or liability that reflect our assumptions that market participants would use in pricing the asset or liability.

## Table of Contents

We make an effort to utilize the best available information in measuring fair value. Our money market funds, which are considered cash and cash equivalents, and our marketable securities, which are considered available-for-sale, are recorded at fair value. We regularly monitor and evaluate the realizable value of our marketable securities. When assessing marketable securities for other-than-temporary declines in value, we consider such factors as, among other things, how significant the decline in value is as a percentage of the original cost, how long the market value of the investment has been less than its original cost, the performance of the issuer's stock price in relation to the stock price of its competitors within the industry and the market in general, analyst recommendations, any news that has been released specific to the issuer, and the outlook for the overall industry in which the issuer operates. If events and circumstances indicate that a decline in the value of these assets has occurred and is other than temporary, we record a charge against net earnings. Financial assets are classified in their entirety based on the lowest level of input that is significant to the fair value measurement. We have determined that our money market funds are Level 1 and our marketable securities are Level 2 in the fair value hierarchy. The following table sets forth our financial assets that were accounted for at fair value on a recurring basis as of June 29, 2008 (in thousands):

	Total	Fair Value Measurements Using		
		Level 1	Level 2	Level 3
<b>Assets</b>				
Money market funds (1)	\$14,760	\$ 14,760	\$ —	\$ —
U.S. government agency obligations (2)	14,489	—	14,489	—
Corporate notes and bonds (2)	4,442	—	4,442	—
Total assets	<u>\$33,691</u>	<u>\$ 14,760</u>	<u>\$ 18,931</u>	<u>\$ —</u>

- (1) Included in cash and cash equivalents in the consolidated balance sheets. Quoted market prices in active markets were used to determine fair values.
- (2) Included in marketable securities in the consolidated balance sheets. Observable market prices in less active markets or quoted market prices for similar instruments were used to determine fair values.

#### 4. Net Loss Per Share

We compute net loss per share using the weighted average number of shares of common stock outstanding. We exclude shares associated with stock options, warrants, and our employee stock purchase plan from the calculation of diluted net loss per share, as their effects are anti-dilutive.

As of June 29, 2008 and July 1, 2007, there were 18,339,806 and 18,058,740 shares, respectively, of common stock subject to outstanding stock options and 900,000 and 815,000 shares, respectively, of common stock subject to warrants, all of which we excluded from the computation of diluted net loss per share, as their effect was anti-dilutive. If we had reported net income, the calculation of these per share amounts would have included the dilutive effect of these common stock equivalents using the treasury stock method.

#### 5. Stockholders' Equity

##### *Stock-Based Benefit Plans*

**1998 Stock Plan** – Under the terms of our 1998 Stock Plan, as amended (1998 Stock Plan), our board of directors could grant incentive and nonqualified stock options to employees, officers, directors, agents, consultants, and independent contractors of drugstore.com. Options under this plan generally vest over four years, as follows: 20% of the shares vest after six months, and the remaining 80% vest quarterly over the subsequent 42 months. Option grants generally had exercise prices equal to the fair market value of the common stock on the date of grant and expire ten years from the date of grant. In June 2008, the 1998 Stock Plan was replaced with the 2008 Equity Incentive Plan (2008 Equity Plan) and no further awards have been or will be granted under the 1998 Stock Plan. The 1998 Stock Plan, however, will continue to govern awards previously granted under that plan and any outstanding options will continue to vest and will remain outstanding until they are exercised, are forfeited, or expire.

---

## Table of Contents

2008 Equity Incentive Plan – In June 2008, our stockholders approved the 2008 Equity Plan, which replaced our 1998 Stock Plan. Under the terms of the 2008 Equity Plan, our board of directors may grant stock options, stock appreciation rights, restricted stock, restricted stock units, performance shares and performance units, and other stock or cash awards to employees, directors, and consultants who provide services to drugstore.com. The board of directors has reserved 8,000,000 shares of our common stock for issuance under the 2008 Equity Plan, as well as up to 15,000,000 shares from stock options or similar awards granted under the 1998 Stock Plan that expire or otherwise terminate without having been exercised in full and shares issued pursuant to awards granted under the 1998 Stock Plan that are forfeited or that we repurchase. The shares may be authorized, but unissued, or reacquired common stock.

Under the 2008 Equity Plan, options will generally vest over four years, as follows: 20% of the shares vest after six months, and the remaining 80% vest quarterly over the subsequent 42 months. The exercise price of options granted under the 2008 Equity Plan must be at least equal to the fair market value of our common stock on the date of grant. In addition, the exercise price of an incentive stock option granted to any participant who owns more than 10% of the total voting power of all classes of our outstanding stock must be at least 110% of the fair market value of the common stock on the grant date. The term of an option may not exceed ten years, except that, with respect to any participant who owns 10% of the voting power of all classes of our outstanding capital stock, the term of an incentive stock option may not exceed five years.

Under the 2008 Equity Plan, stock appreciation rights, which are the rights to receive the appreciation in fair market value of common stock between the exercise date and the date of grant, become exercisable at the times and on the terms established by the plan administrator. The plan administrator has complete discretion to determine the terms and conditions of stock appreciation rights granted under the 2008 Equity Plan; provided, however, that the exercise price may not be less than 100% of the fair market value of a share on the date of grant. The term of a stock appreciation right may not exceed ten years. Under the 2008 Equity Plan, the plan administrator may issue awards of restricted stock, restricted stock units, and performance units and performance shares at its sole discretion.

1999 Employee Stock Purchase Plan - Under the terms of our 1999 Employee Stock Purchase Plan, as amended (1999 ESPP), eligible employees may purchase common stock for a purchase price equal to 85% of the fair market value of our common stock on the first or last day, whichever is less, of the applicable six-month purchase period, which periods end in January and July of each year. During the six-month period ended June 29, 2008, employees purchased 35,978 shares of our common stock under the 1999 ESPP in exchange for approximately \$87,000, and during the six-month period ended July 1, 2007, employees purchased 55,193 shares of our common stock under the 1999 ESPP in exchange for approximately \$130,000.

### **Warrants**

In June 2008, we issued a fully vested warrant to purchase 50,000 shares of our common stock at \$2.53 per share, expiring in June 2018, in conjunction with a consulting agreement. The fair value of the warrant, determined using the Black-Scholes option pricing model, was \$69,000 and was recorded in general and administrative expenses in the consolidated statements of operation.

In March 2008, we issued two fully vested warrants to purchase 50,000 shares (in total, 100,000 shares) of our common stock at \$2.53 per share, expiring in March 2018, in conjunction with a consulting agreement. The fair value of the warrants, determined using the Black-Scholes option pricing model, totaled \$163,000 and was recorded in general and administrative expenses in the consolidated statements of operation.

In February 2008, an outstanding warrant to purchase 115,000 shares of our common stock was exercised in exchange for \$271,400.

### **Stock-Based Compensation Expense**

We account for the 1998 Stock Plan, 2008 Equity Plan, and the 1999 ESPP under the recognition and measurement principles of FASB Statement No. 123 (revised 2004), *Share-Based Payment* (SFAS 123R), which requires measurement of compensation cost for all stock-based awards at fair value on the date of grant and recognition of compensation over the service period for awards expected to vest. We determine the fair value of stock-based awards using the Black-Scholes option pricing model using the single option award approach. This fair value is then amortized on a straight-line basis over the requisite service periods of the awards, which is generally the vesting period. As required by SFAS 123R, management made an estimate of expected forfeitures, and we are recognizing compensation costs only for those equity awards expected to vest. The estimation of stock awards that will ultimately vest requires judgment, and to the extent actual results or updated estimates differ from our current estimates, we will record such amounts retrospectively as an increase or decrease in stock-based compensation in the period in which we revise the estimates. We consider many factors when estimating expected forfeitures, including historical voluntary termination behavior and actual option forfeitures. Actual results, and future changes in estimates, may differ substantially from our current estimates.

## Table of Contents

The following table summarizes stock-based compensation by operating function recorded in the Statements of Operations (in thousands):

	Three Months Ended		Six Months Ended	
	June 29, 2008	July 1, 2007	June 29, 2008	July 1, 2007
Fulfillment and order processing	\$ 103	\$ 186	\$ 288	\$ 461
Marketing and sales	417	372	732	786
Technology and content	246	285	604	643
General and administrative	1,082	1,693	2,308	3,077
Total	<u>\$ 1,848</u>	<u>\$ 2,536</u>	<u>\$3,932</u>	<u>\$4,967</u>

### Stock Option Activity

The following table summarizes activity under our 1998 Stock Plan and 2008 Equity Plan:

	Outstanding Options		Weighted-Average Remaining Contractual Term
	Number of Shares	Weighted-Average Exercise Price per Share	
Outstanding at December 30, 2007	<u>16,742,358</u>	\$ 3.48	
Options granted	2,821,190	\$ 2.63	
Options exercised	(30,908)	\$ 2.09	
Options forfeited	(1,192,834)	\$ 4.73	
Outstanding at June 29, 2008	<u>18,339,806</u>	\$ 3.27	
Vested and expected to vest at June 29, 2008	<u>12,854,660</u>	\$ 3.37	<u>6.88</u>
Exercisable at June 29, 2008	<u>8,911,160</u>	\$ 3.57	<u>6.32</u>

## 6. Line of Credit and Debt Obligations

In March 2008, we entered into an amended and restated loan and security agreement with our existing bank. This agreement includes a revolving line of credit allowing for borrowings of up to \$10.0 million, which accrue interest at the prime rate. The revolving line of credit matures in March 2009. The agreement allows for the conversion of up to \$5.0 million of the outstanding balance into a term loan within 60 days of maturity. In March 2008, borrowings under the existing line of credit totaling \$5.0 million and existing term loans totaling \$972,222 were converted into one term loan totaling \$6.0 million under the amended and restated loan and security agreement. The term loan is payable in 36 monthly installments and accrues interest at the prime rate plus .50% (5.50% at June 29, 2008). The balance outstanding under the term loan totaled \$5.5 million as of June 29, 2008.

## 7. Commitments and Contingencies

### Legal Proceedings

*1-800 Contacts Litigation*. On February 26, 2008, 1-800 Contacts, Inc. (1-800 Contacts) filed an action in the U.S. District Court for the District of Utah, Central Division against us and our subsidiary Vision Direct alleging direct and contributory trademark infringement and dilution under federal and state law, unfair competition, intentional interference with economic relations, and unjust enrichment. One day later, on February 27, 2008, 1-800 Contacts filed a separate action in the U.S. District Court for the Southern District of New York against Vision Direct alleging breach of a 2004 settlement agreement between Vision Direct and 1-800 Contacts. In both actions, 1-800 Contacts seeks monetary damages as well as injunctive relief. In the Utah action, we filed a motion to dismiss for improper venue or, in the alternative, to transfer the case to the U.S. District Court for the Southern District of New York. This motion is fully briefed and oral argument is scheduled for August 11, 2008. In the New York action, we filed an answer denying that 1-800 Contacts is entitled to the relief requested and counterclaims asserting, among other things, that 1-800 Contacts' pursuit of the Utah action constitutes a violation of the settlement agreement's forum selection clause. 1-800 Contacts filed a Motion to Dismiss our counterclaims, which motion is now fully briefed. Discovery has not begun in either action. We believe 1-800 Contacts' claims are without merit and intend to defend against them vigorously.

---

## Table of Contents

Due to the inherent uncertainties of litigation, we cannot accurately predict the ultimate outcome of these matters. We are unable to estimate the potential damages that might be awarded if we were found liable. Because our liability, if any, cannot be reasonably estimated, no amounts have been accrued for these matters. An adverse outcome in these matters could have a material adverse effect on our financial position and results of operations.

*Fair Credit Reporting Act Class Action Litigation* . On February 26, 2008, Aaron Burgess and John James Garland filed a class action lawsuit against us in the U.S. District Court for the Western District of Washington at Seattle alleging breach of a provision of the Fair Credit Reporting Act (“FCRA”) related to the printing of credit card receipts. The lawsuit seeks statutory and punitive damages. We were served with the complaint on March 7, 2008 and filed our answer on April 17, 2008. In May 2008, Congress passed legislation that clarified FCRA and rendered the lawsuit moot. As such, plaintiffs filed a motion to dismiss with prejudice. On May 28, 2008, the Order of Dismissal was entered, and the litigation ended.

*State Sales Tax Claims* . In early 2002, we received an arbitrary assessment notice from the state of New Jersey for past sales tax due from fiscal years 2000 and 2001, based on its best estimate of sales revenue numbers during those periods. In December 2002, we received a revised assessment from the state of New Jersey for 2000 and 2001 in the aggregate amount of \$221,626 in tax, plus penalties in the amount of \$11,081 and interest that continues to accrue. In March 2003, we filed an appeal of the revised assessment with the Tax Court of New Jersey, based on the fact that the state of New Jersey is pursuing its claim specifically against one of our consolidated subsidiaries that is not a retailing entity in that state. On February 19, 2008, we were informed of the decision by the Tax Court of New Jersey against us in the case of *drugstore.com, inc. vs. Director, Division of Taxation* (the NJ Tax Case). We did not believe that it was required to collect sales taxes on sales made to customers in New Jersey based on applicable law. In its decision, the Tax Court of New Jersey ruled otherwise. Prior to this ruling we had not collected sales tax in New Jersey. We filed our Notice of Appeal of the Tax Court’s decision on March 31, 2008 and we are considering our other legal options. A briefing schedule with the Superior Court of New Jersey, Appellate Division, has been set, and we anticipate the appeal will be fully briefed by mid-September 2008. Effective March 2008, we began collecting and remitting sales tax on taxable New Jersey sales. Given the decision, we believe that it is probable that we have incurred a liability of \$2.5 million for estimated taxes and interest. Accordingly, we recorded an expense in general and administrative expenses in the consolidated statement of operations during the year ended December 30, 2007. The liability is an estimate of the New Jersey tax obligation for the 2000 and 2001 assessment that gave rise to the NJ Tax Case, as well as for all subsequent years through 2007. For the three-and six- months ended June 29, 2008, we have recorded an additional \$73,000 and \$234,000, respectively, of estimated uncollected taxes related to 2008 and interest.

*Class Action Laddering Litigation* . A Consolidated Amended Complaint, which is now the operative complaint, was filed on April 19, 2002 in the United States District Court for the Southern District of New York (the Court). It names *drugstore.com* as a defendant, along with the underwriters and certain of our present and former officers and directors (the Individual Defendants), in connection with our July 27, 1999 initial public offering and March 15, 2000 secondary offering (together, the Offerings). The suit purports to be a class action filed on behalf of purchasers of our common stock during the period July 28, 1999 to December 6, 2000.

In general, the complaint alleges that the prospectuses through which we conducted the Offerings were materially false and misleading because they failed to disclose, among other things, that (i) the underwriters of the Offerings allegedly had solicited and received excessive and undisclosed commissions from certain investors in exchange for which the underwriters allocated to those investors material portions of the restricted number of shares issued in connection with the Offerings and (ii) the underwriters allegedly entered into agreements with customers whereby the underwriters agreed to allocate *drugstore.com* shares to customers in the Offerings in exchange for which customers agreed to purchase additional *drugstore.com* shares in the after-market at predetermined prices. The complaint asserts violations of various sections of the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended. The action seeks damages in an unspecified amount and other relief. The action is being coordinated with approximately 300 other nearly identical actions filed against other companies or their present and former officers and directors.

On October 9, 2002, the Court dismissed the Individual Defendants from the case without prejudice. On December 5, 2006, the Second Circuit vacated a decision by the district court granting class certification in six of the coordinated cases, which are intended to serve as test, or “focus,” cases. The plaintiffs selected these six cases, which do not include us. On April 6, 2007, the Second Circuit denied a petition for rehearing filed by plaintiffs, but noted that plaintiffs could ask the district court to certify more narrow classes than those that were rejected.

On August 14, 2007, the plaintiffs filed amended complaints in the six focus cases. The amended complaints include a number of changes, such as changes to the definition of the purported class of investors, and the elimination of the individual defendants as defendants. The six focus case issuers and the underwriters named as defendants in the focus cases filed motions to dismiss the amended complaints against them on November 14, 2007. On September 27, 2007, the plaintiffs filed a motion for class certification

---

## Table of Contents

in the six focus cases. On March 26, 2008, the District Court dismissed the Securities Act claims of those members of the putative classes in the focus cases who sold their securities for a price in excess of the initial offering price and those who purchased outside the previously certified class period. With respect to all other claims, the motions to dismiss were denied. We are awaiting a decision from the Court on the class certification motion.

Due to the inherent uncertainties of litigation, we cannot accurately predict the ultimate outcome of this matter. We cannot predict whether we will be able to renegotiate a settlement that complies with the Second Circuit's mandate, nor can we predict the amount of any such settlement and whether that amount would be greater than our insurance coverage. We are unable to estimate the potential damages that might be awarded if we were found liable, there arose a material limitation with respect to our insurance coverage, or the amount awarded were to exceed our insurance coverage. Because our liability, if any, cannot be reasonably estimated, no amounts have been accrued for this matter. An adverse outcome in this matter could have a material adverse effect on our financial position and results of operations.

*Other.* From time to time, we are subject to other legal proceedings and claims in the ordinary course of business. We are not currently aware of any such legal proceedings or claims that we believe will have, individually or in the aggregate, a material adverse effect on our business prospects, financial condition, or operating results, other than those listed above.

### 8. Segment Information

We have four reporting segments: OTC, vision, mail-order pharmacy, and local pick-up pharmacy. The OTC segment is comprised of the sales and related costs of selling all non-prescription products through our web stores, customized nutritional supplement programs through CNS, and net sales of consignment products. Our vision segment is comprised of sales and the related costs of selling contact lenses through Vision Direct. The mail-order pharmacy segment is comprised of sales and the related costs of selling pharmaceuticals through the drugstore.com web store for mail-order delivery. The local pick-up pharmacy segment is comprised of sales and the related costs of selling pharmaceuticals through the drugstore.com web store and the RiteAid.com web store for pick-up at a local Rite Aid store. We operate and evaluate our business segments based on contribution margin results. We define contribution margin as net sales attributable to a segment, less the direct cost of these sales and the incremental (variable) costs of fulfilling, processing, and delivering the order (labor, packaging supplies, credit card fees, and royalty costs that are variable based on sales volume).

## Table of Contents

The information presented below for these segments is information our management uses in evaluating operating performance.

	Three Months Ended		Six Months Ended	
	June 29, 2008	July 1, 2007	June 29, 2008	July 1, 2007
	(in thousands)		(in thousands)	
<b>Over-the-Counter (OTC):</b>				
Net sales	\$ 64,911	\$ 57,527	\$129,762	\$113,789
Cost of sales	45,099	40,810	90,112	80,461
Variable order costs (a)	5,869	5,180	11,834	10,548
Contribution margin (b)	<u>\$ 13,943</u>	<u>\$ 11,537</u>	<u>\$ 27,816</u>	<u>\$ 22,780</u>
<b>Vision:</b>				
Net sales	\$ 15,850	\$ 13,795	\$ 31,286	\$ 27,347
Cost of sales	12,238	10,475	24,266	20,971
Variable order costs (a)	747	651	1,490	1,298
Contribution margin (b)	<u>\$ 2,865</u>	<u>\$ 2,669</u>	<u>\$ 5,530</u>	<u>\$ 5,078</u>
<b>Mail-Order Pharmacy:</b>				
Net sales	\$ 11,487	\$ 12,451	\$ 23,768	\$ 25,929
Cost of sales	9,342	10,466	19,484	21,779
Variable order costs (a)	904	952	1,833	2,073
Contribution margin (b)	<u>\$ 1,241</u>	<u>\$ 1,033</u>	<u>\$ 2,451</u>	<u>\$ 2,077</u>
<b>Local Pick-Up Pharmacy:</b>				
Net sales (c)	\$ 30,539	\$ 26,639	\$ 58,608	\$ 53,112
Cost of sales	26,629	23,566	51,169	47,168
Variable order costs (a)	1,238	1,101	2,388	2,189
Contribution margin (b)	<u>\$ 2,672</u>	<u>\$ 1,972</u>	<u>\$ 5,051</u>	<u>\$ 3,755</u>
<b>Consolidated:</b>				
Net sales	\$122,787	\$110,412	\$243,424	\$220,177
Cost of sales	93,308	85,317	185,031	170,379
Variable order costs (a)	8,758	7,884	17,545	16,108
Consolidated contribution margin (b)	<u>\$ 20,721</u>	<u>\$ 17,211</u>	<u>\$ 40,848</u>	<u>\$ 33,690</u>
<b>Less:</b>				
Fixed fulfillment and order processing (d)	\$ 3,451	\$ 2,794	\$ 6,845	\$ 5,561
Marketing and sales (e)	8,796	7,850	17,651	15,922
Technology and content	5,736	4,475	10,939	9,190
General and administrative	4,900	5,157	10,294	9,866
Amortization of intangible assets	210	306	455	750
Operating loss	<u>\$ (2,372)</u>	<u>\$ (3,371)</u>	<u>\$ (5,336)</u>	<u>\$ (7,599)</u>

- (a) These amounts include all variable costs of fulfillment and order processing, including labor, packaging supplies, credit card fees, and those royalty costs that are variable based on sales volume. These amounts exclude depreciation, stock-based compensation, and fixed overhead costs.
- (b) Contribution margin represents a measure of how well each segment is contributing to our operating goals. We calculate it as net sales less the direct cost of goods sold, the incremental (variable) fulfillment and order processing costs of delivering orders to our customers, and variable royalty costs.
- (c) Net sales in our local pick-up pharmacy segment include co-payments totaling \$6.4 million and \$5.8 million for the three-month periods ended June 29, 2008 and July 1, 2007, respectively, and \$12.5 million and \$11.7 million for the six-month periods ended June 29, 2008 and July 1, 2007, respectively.
- (d) These amounts include all fixed costs of fulfillment and order processing that are not discernable by business segment.
- (e) These amounts exclude variable royalty expenses of \$25,000 and \$22,000 for the three-month periods ended June 29, 2008, and July 1, 2007, respectively, and \$56,000 and \$39,000 for the six-month periods ended June 29, 2008 and July 1, 2007, respectively.

---

## Table of Contents

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

You should read the following discussion and analysis in conjunction with the financial statements and accompanying notes included elsewhere in this quarterly report and in our annual report on Form 10-K for the fiscal year ended December 30, 2007.

#### Special Note Regarding Forward-Looking Statements

This quarterly report on Form 10-Q includes forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. All statements made in this quarterly report other than statements of historical fact, including statements regarding our future financial and operational performance, sources of liquidity and future liquidity needs, are forward-looking. Words such as “expects,” “believes,” “targets,” “may,” “will,” “outlook,” “continue,” “could,” “would,” “should,” and similar expressions or any variation of such expressions, are intended to identify forward-looking statements. Forward-looking statements are based on current expectations, and are not guarantees of future performance and involve assumptions, risks, and uncertainties. Actual performance may differ materially from those contained or implied in such forward-looking statements. Risks and uncertainties that could lead to such differences could include, among other things: effects of changes in the economy, changes in consumer spending, fluctuations in the stock market, changes affecting the Internet, online retailing and advertising, difficulties establishing our brand and building a critical mass of customers, the unpredictability of future revenues and expenses and potential fluctuations in revenues and operating results, risks related to business combinations and strategic alliances, possible tax liabilities relating to the collection of sales tax, consumer trends, the level of competition, seasonality, the timing and success of expansion efforts, changes in senior management, risks related to systems interruptions, possible governmental regulation, and the ability to manage a growing business. These factors described in this paragraph and other risks and uncertainties that could cause our actual results to differ significantly from management's expectations are discussed in the sections entitled “*Risk Factors*” in Part II, Item 1A of this quarterly report and Part I, Item 1A of our annual report on Form 10-K for the fiscal year ended December 30, 2007. You should not rely on a forward-looking statement as representing our views as of any date other than the date on which we made the statement. We expressly disclaim any intent or obligation to update any forward-looking statement after the date on which we make it.

#### Overview

drugstore.com, inc. is a leading online provider of health, beauty, vision, and pharmacy products. We believe that we offer a better way for consumers to shop for these products through our web stores, including those located on the Internet at [www.drugstore.com](http://www.drugstore.com), [www.beauty.com](http://www.beauty.com), [www.visiondirect.com](http://www.visiondirect.com), [www.lensmart.com](http://www.lensmart.com), and [www.lensquest.com](http://www.lensquest.com).

*Business Segments; Growth Strategies.* We operate our business in four business segments: over-the-counter, or OTC, vision, mail-order pharmacy, and local pick-up pharmacy.

- *Over-the-counter (OTC)* . Our OTC segment includes all non-prescription products sold online through our web stores at [www.drugstore.com](http://www.drugstore.com), [www.beauty.com](http://www.beauty.com), [www.visiondirect.com](http://www.visiondirect.com), [www.lensmart.com](http://www.lensmart.com), and [www.lensquest.com](http://www.lensquest.com), or over the telephone at 1-800-DRUGSTORE or 1-800-VISIONDIRECT, including nutritional supplements sold through our subsidiary Custom Nutrition Services, Inc., or CNS. We source our OTC products from various manufacturers and distributors. We also sell advertising on our primary OTC site [www.drugstore.com](http://www.drugstore.com). We believe leveraging our strong capabilities in Internet marketing, merchandising, fulfillment, and customer care in the health, beauty, and wellness arena will be a key growth driver for our OTC segment. In the second half of 2008, we are focusing on key initiatives to accelerate OTC growth through strategic partnerships and international expansion.
- *Vision* . The vision segment includes contact lenses sold through our wholly owned subsidiary Vision Direct Inc. (Vision Direct), through web stores located at [www.visiondirect.com](http://www.visiondirect.com), [www.lensmart.com](http://www.lensmart.com), and [www.lensquest.com](http://www.lensquest.com), or over the telephone at 1-800-VISIONDIRECT. We purchase our contact lens inventory directly from various manufacturers and other distributors. In the second half of 2008, we anticipate growth in our vision segment year-over-year as we continue to focus on balancing customer acquisition with net margin in order to maximize our profits.
- *Mail-Order Pharmacy* . Our mail-order pharmacy segment includes prescription drugs and supplies, other than prescription contact lenses, sold online through the pharmacy section of the drugstore.com web store or over the telephone and delivered to customers through our mail-order facility. We procure our prescription inventory through Rite Aid Corporation as part of our ongoing relationship. We market to both cash-paying and insurance-covered individuals, and we also serve as a third-party provider of mail-order prescription fulfillment services for pharmacy benefit managers, or PBMs. We sell over 5,000 prescription drugs, including many specialty drugs for the treatment of chronic conditions such as cancer, HIV, and multiple sclerosis, which are not carried by brick-and-mortar pharmacies and require special handling or service.

## Table of Contents

In this segment, we focus our marketing efforts directly on consumers online and through doctors to maximize growth in our cash prescription and specialty pharmacy business. In addition to the sale of prescription drugs, we sell advertising on our website, to monetize the more than one million unique visitors per month researching drugs and other healthcare content provided on the site. In the second half of 2008, we anticipate that our mail-order pharmacy segment revenues may decline due to the acquisition of one of our PBMs, but anticipate year-over-year contribution margin improvements.

- *Local Pick-Up Pharmacy* . Our local pick-up pharmacy business segment includes prescription refills sold online through the drugstore.com web store or the Rite Aid web store at [www.RiteAid.com](http://www.RiteAid.com) (which is powered by the drugstore.com web store) or over the telephone and picked up by customers at Rite Aid stores. In this segment, Rite Aid acts as our fulfillment partner. Our success in this segment depends on our ability to leverage our relationship with Rite Aid through its marketing media, including Rite Aid store receipts, weekly Rite Aid advertising circulars, and e-mail refill reminders. We are currently in negotiations with Rite Aid regarding the terms of our existing local-pick up pharmacy agreement that expires in June 2009.

*Revenues* . We generate revenue primarily from product sales and shipping fees. For the three-month period ended June 29, 2008, we reported consolidated total net sales of \$122.8 million, which reflected a \$12.4 million, or 11%, increase over the three-month period ended July 1, 2007. For the six-month period ended June 29, 2008, we reported consolidated net sales of \$243.4 million, which reflected a \$23.2 million, or 11%, increase over the six-month period ended July 1, 2007. Our net sales growth was driven by a 9% year-over-year increase in our total order volume for the second quarter of 2008, to 1.6 million orders, and a 9% year-over-year increase in total order volume for the six-month period ended June 29, 2008, to 3.2 million orders. Our average net sales per order increased slightly to \$76 for the three- and six-month periods ended June 29, 2008, from \$75 for the three- and six-month periods ended July 1, 2007. Our revenues benefited from strong growth in our OTC segment, which grew net sales by 13% and 14%, respectively, year-over-year for the three- and six-month periods ended June 29, 2008. Our revenues also benefited from year-over-year growth of 15% and 14%, respectively, for the three- and six-month periods ended June 29, 2008 in our vision segment and 15% and 10%, respectively, in our local pick-up pharmacy segment. These increases were partially offset by a year-over-year decrease in mail-order pharmacy net sales of 8% for the three- and six-month periods ended June 29, 2008.

*Expenses* . Our operating expenses, including cost of goods sold, decreased slightly as a percentage of net sales to 102% during the three-month period ended June 29, 2008, from 103% for the three-month period ended July 1, 2007, and also decreased to 102% of net sales for the six-month period ended June 29, 2008 compared to 103% for the six-month period ended July 1, 2007. During the three- and six-month periods ended June 29, 2008 our overall cost of goods sold as a percentage of net sales decreased year-over-year by 130 basis points and 140 basis points, respectively, due to a favorable shift in our product mix to higher margin OTC sales, as well as improvements in our OTC, mail-order pharmacy, and local-pick up pharmacy margins. For the three- and six-month periods ended June 29, 2008, our improved gross margins were partially offset by increased fulfillment expenses resulting from increased professional fees primarily related to consulting services assisting in our profitability initiatives, increased marketing expenses resulting from increased order volumes and increased cost per order, and increased technology and content expenses as a result of ongoing improvements to our IT infrastructure. For the three-month period ended June 29, 2008, general and administrative expenses decreased primarily due to lower stock based compensation expenses partially offset by increased professional fees primarily related to consulting services assisting in our profitability initiatives, and for the three-month period ended July 1, 2007, general and administrative expenses increased as a result of increased professional fees partially offset by lower stock-based compensation.

*Net Loss; Cash Position* . Our net loss for the three-month period ended June 29, 2008 decreased by 25%, or \$743,000 to \$2.3 million, compared to \$3.0 million for the three-month period ended July 1, 2007, and decreased by 27%, or \$1.8 million, to \$5.0 million, compared to \$6.8 million for the six-month period ended July 1, 2007. We ended the second quarter of 2008 with \$35.2 million in cash, cash equivalents, and marketable securities, compared to \$36.2 million at December 31, 2007, and \$38.9 million at July 1, 2007. This balance reflects cash generated from operating activities in the six-month period ended June 29, 2008 of \$4.4 million, \$3.5 million from borrowings under our line of credit, and proceeds of \$423,000 from the exercise of employee stock options and purchases under our employee stock purchase plan, offset by \$8.1 million used for capital expenditures, and \$1.2 million to repay debt obligations.

## Table of Contents

### Results of Operations

#### Net Sales

	Three Months Ended			Six Months Ended		
	June 29, 2008	% Change	July 1, 2007	June 29, 2008	% Change	July 1, 2007
	(in thousands, except per order data)			(in thousands, except per order data)		
Total net sales	\$122,787	11.2%	\$110,412	\$243,424	10.6%	\$220,177
Total customer orders shipped	1,616	9.4%	1,477	3,204	8.5%	2,954
Average net sales per order	\$ 76	1.3%	\$ 75	\$ 76	1.3%	\$ 75

Net sales include gross revenues from sales of product and related shipping fees, net of discounts and provision for sales returns, and other allowances. Net sales also include consignment service fees earned from our arrangement with GNC and other consignment vendors, under which we do not take title to the inventory and cannot establish pricing. We record on a net basis consignment service fees, which constitute approximately 1% of total net sales in each period presented. We bill orders to the customer's credit card or, in the case of prescriptions covered by insurance, we bill the co-payment to the customer's credit card and the remainder of the prescription price to insurance. We record sales of pharmaceutical products covered by insurance as the sum of the amounts received from the customer and the third party.

Total net sales increased year-over-year primarily as a result of a 9% increase in order volume and an increase in our average net sales per order for the three- and six-month periods ended June 29, 2008. Revenues from repeat customers decreased to 81% of net sales in the three- and six-month periods ended June 29, 2008, compared to 83% for the same periods of 2007, primarily as a result of a decrease in revenue from repeat customers in our vision and mail-order pharmacy segments. The year-over-year increase in average net sales per order for the three- and six-month periods ended June 29, 2008 resulted from improvements in all of our segments' net sales per order. Compared to the three- and the six-month periods ended July 1, 2007, net sales in our OTC segment increased by \$7.4 million and \$16.0 million, net sales in our local pick-up pharmacy segment increased by \$3.9 million and \$5.5 million, and net sales in our vision segment increased by \$2.1 million and \$3.9 million, respectively. These increases were partially offset by decreases in net sales in our mail-order pharmacy segment of \$1.0 million and \$2.2 million, respectively.

#### OTC Net Sales

	Three Months Ended			Six Months Ended		
	June 29, 2008	% Change	July 1, 2007	June 29, 2008	% Change	July 1, 2007
	(in thousands, except per order data)			(in thousands, except per order data)		
OTC net sales	\$64,911	12.8%	\$57,527	\$129,762	14.0%	\$113,789
<i>Segmented net sales information:</i>						
% of total net sales from OTC	52.9%		52.1%	53.3%		51.7%
Average net sales per order	\$ 58	1.8%	\$ 57	\$ 58	1.8%	\$ 57

Net sales in our OTC segment increased year-over-year for the three- and six-month periods ended June 29, 2008 as a result of an increase in order volume and net sales per order. The number of orders in our OTC segment grew year-over-year by 11% to 1.1 million for the second quarter of 2008, compared to 1.0 million for the second quarter of 2007, with the average net sales per order for the second quarter of 2008 increasing year-over-year to \$58 from \$57. During the six-month period ended June 29, 2008, the number of OTC orders grew year-over-year by 11% to 2.2 million, compared to 2.0 million in the same period of 2007, and the average net sales per order also increased to \$58 from \$57. The number of customer orders includes new and repeat orders made through the drugstore.com web store and the web stores of our subsidiaries and orders generated through our fulfillment agreement with Weil, under which we host a Weil-branded store and fulfill Weil vitamin orders made on the drugstore.com web store. The increase in OTC order volumes in 2008 compared to 2007 was driven by increased orders from both new and repeat customers as a result of our increasing active customer base and our continued efforts to improve customer retention and conversion by adding website enhancements and offering a broad selection of basic necessity items and hard-to-find specialty items through the addition of new SKUs that encourages customers to return to our websites and make repeat, replenishment, and impulse purchases. The increase in the average net sales per order in our OTC segment in 2008 compared to 2007 resulted from selling higher-priced items, offset slightly by a decrease in the number of items per order.

## Table of Contents

### Vision Net Sales

	Three Months Ended			Six Months Ended		
	June 29, 2008	% Change	July 1, 2007	June 29, 2008	% Change	July 1, 2007
	(in thousands, except per order data)			(in thousands, except per order data)		
Vision net sales	\$15,850	14.9%	\$13,795	\$31,286	14.4%	\$27,347
<i>Segmented net sales information:</i>						
% of total net sales from vision	12.9%		12.5%	12.8%		12.4%
Average net sales per order	\$ 111	12.1%	\$ 99	\$ 109	12.4%	\$ 97

Net sales in our vision segment increased year-over-year for the three- and six-month periods ended June 29, 2008 as a result of an increase in the average net sales per order, and to a lesser extent, an increase in orders. The increase in average net sales per order was driven primarily by offering volume discounts, which result in an increase in the average number of items sold per order, and to a lesser extent, selling higher priced, newer technology contact lenses and price increases for certain SKUs (none of which were individually material). The number of orders in this segment increased slightly to 143,000 for the three-month period ended June 29, 2008, compared to 140,000 for the three-month period ended July 1, 2007, and increased to 286,000 for the six-month period ended June 29, 2008, compared to 281,000 for the six-month period ended July 1, 2007 as a result of an increase in orders from new customers partially offset by a decrease in orders from repeat customers.

### Mail-Order Pharmacy Net Sales

	Three Months Ended			Six Months Ended		
	June 29, 2008	% Change	July 1, 2007	June 29, 2008	% Change	July 1, 2007
	(in thousands, except per order data)			(in thousands, except per order data)		
Mail-order pharmacy net sales	\$11,487	-7.7%	\$12,451	\$23,768	-8.3%	\$25,929
<i>Segmented net sales information:</i>						
% of total net sales from mail-order pharmacy	9.3%		11.3%	9.8%		11.8%
Average net sales per order	\$ 161	0.6%	\$ 160	\$ 162	1.3%	\$ 160

Net sales in our mail-order pharmacy segment decreased year-over-year for the three- and six-month periods ended June 29, 2008 as a result of decreases in order volume, partially offset by a slight increase in the average net sales per order. Included in net sales of our mail-order pharmacy segment for the three-month periods ended June 29, 2008 and July 1, 2007 were wholesale orders to two parties totaling \$388,000 and \$336,000, respectively, which increased our average net sales per order by \$5 and \$4 in the second quarter. Included in net sales of our mail-order pharmacy segment for the six-month periods ended June 29, 2008 and July 1, 2007 were wholesale orders to two parties totaling \$1.4 million and \$950,000, respectively, which increased our average net sales per order by \$9 and \$6 in the six-month periods ended. The number of orders in this segment decreased 9% year-over-year to 71,000 for the three-month period ended June 29, 2008, compared to 78,000 for the same period in 2007, and decreased 10% year-over-year to 146,000 for the six-month period ended June 29, 2008, compared to 162,000 for the same period in 2007, as a result of decreases in repeat orders. Excluding the wholesale orders, the average net sales per order for the second quarter of 2008 remained flat compared to the same period in 2007, and decreased by \$1 for the six-month period ended 2008 compared to the same period in 2007, as a result of a decrease in prescription sales of higher-priced brand name drugs compared to lower-priced generic prescription drugs.

## Table of Contents

### Local Pick-up Pharmacy Net Sales

	Three Months Ended			Six Months Ended		
	June 29, 2008	% Change	July 1, 2007	June 29, 2008	% Change	July 1, 2007
Local pick-up pharmacy net sales	\$30,539	14.6%	\$26,639	\$58,608	10.3%	\$53,112
<i>Segmented net sales information:</i>						
% of total net sales from local pick-up pharmacy	24.9%		24.1%	24.1%		24.1%
Average net sales per order	\$ 108	2.9%	\$ 105	\$ 107	1.9%	\$ 105

Net sales in our local pick-up pharmacy segment increased year-over-year for the three- and six-month periods ended June 29, 2008 as a result of an increase in order volume and average net sales per order. The number of orders in this segment increased 12% year-over-year to 283,000 for the three-month period ended June 29, 2008, compared to 253,000 for the three-month period ended July 1, 2007, and increased 9% to 547,000 for the six-month period ended June 29, 2008, compared to 504,000 for the six-month period ended July 1, 2007 as a result of an increase in orders from new and repeat customers. Orders in this segment are driven by Rite Aid through its marketing media, including Rite Aid store receipts, weekly Rite Aid advertising circulars, and e-mail refill reminders, and by Rite Aid's adding additional stores. The average net sales per order increased year-over-year for the three- and six-months period ended June 29, 2008 as a result of an increase in the price per prescription for brand name drugs, partially offset by selling a higher proportion of generic drugs, which have a lower per prescription price.

### Customer Data

Approximately 382,000 and 756,000 new customers placed orders during the three- and six-month periods ended June 29, 2008, respectively, increasing our total customer base to approximately 10.6 million customers since inception. Orders from repeat customers as a percentage of total orders decreased slightly year-over-year to 76% for the three- and six-months ended June 29, 2008, compared to 77% for the same periods in 2007, as a result of a decrease in repeat orders from our vision and mail-order pharmacy segments, partially offset by an increase in our trailing 12-month active customer base. Active customer base includes those customers who have purchased at least once within the last 12 months. Both the active customer base (a trailing 12-month number) and average annual spend per active customer exclude net sales and orders generated by our CNS fulfillment relationship with Weil, and reflect only the activity of customers making purchases through the web stores of drugstore.com and its subsidiaries.

### Cost of Sales and Gross Margin

	Three Months Ended			Six Months Ended		
	June 29, 2008	% Change	July 1, 2007	June 29, 2008	% Change	July 1, 2007
Cost of sales	\$93,308	9.4%	\$85,317	\$185,031	8.6%	\$170,379
Gross margin dollars	\$29,479	17.5%	\$25,095	\$ 58,393	17.3%	\$ 49,798
Gross margin percentage	24.0%		22.7%	24.0%		22.6%

Cost of sales consists primarily of the cost of products sold to our customers, including allowances for shrinkage and damaged, slow-moving, and expired inventory, outbound and inbound shipping costs, and expenses related to promotional inventory included in shipments to customers. Payments that we receive from vendors in connection with volume purchase or rebate allowances and payment discount terms are netted against cost of sales.

Total cost of sales increased in absolute dollars in the three- and six-month periods ended June 29, 2008, compared to the three- and six-month periods ended July 1, 2007, as a result of growth in order volume and net sales. Total gross margin percentage increased year-over-year for the three- and six-month periods ended June 29, 2008, primarily as a result of a larger proportion of net sales in our OTC segment, which is our highest-margin segment, and improved gross margins in our mail-order and local pick-up pharmacy segments.

## Table of Contents

### Shipping

	Three Months Ended			Six Months Ended		
	June 29, 2008	% Change (\$ in thousands)	July 1, 2007	June 29, 2008	% Change (\$ in thousands)	July 1, 2007
<b>Shipping activity:</b>						
Shipping revenue	\$ 3,960	0.0%	\$ 3,962	\$ 7,900	2.2%	\$ 7,732
Shipping costs	(\$6,634)	5.5%	(\$6,291)	(\$13,312)	10.2%	(\$12,078)
Net shipping loss	(\$2,674)	14.8%	(\$2,329)	(\$ 5,412)	24.5%	(\$ 4,346)
<b>Percentage of net sales:</b>						
Shipping revenue	3.2%		3.6%	3.2%		3.5%
Shipping costs	-5.4%		-5.7%	-5.5%		-5.5%
Net shipping loss	-2.2%		-2.1%	-2.2%		-2.0%

Our net shipping loss increased in absolute dollars and as a percentage of net sales in the three- and six-month periods ended June 29, 2008, compared to the same periods in 2007, as a result of a higher mix of OTC orders, which have a higher net shipping loss than orders in our other business segments, and increasing fuel surcharges. In late 2007, we renegotiated lower contractual rates from our largest shipping carrier, and in early 2008, we implemented our zone skipping program, which we anticipate will have a favorable impact on our net shipping loss in 2008. We include in net sales our revenues from shipping charges to customers and we include in cost of sales outbound shipping costs. We expect to continue to subsidize a portion of customers' shipping costs for the foreseeable future, through certain free shipping options, as a strategy to attract and retain customers.

### OTC Cost of Sales and Gross Margin

	Three Months Ended			Six Months Ended		
	June 29, 2008	% Change (\$ in thousands)	July 1, 2007	June 29, 2008	% Change (\$ in thousands)	July 1, 2007
OTC cost of sales	\$45,099	10.5%	\$40,810	\$90,112	12.0%	\$80,461
<i>Segmented cost of sales information:</i>						
OTC gross margin dollars	\$19,812		\$16,717	\$39,650		\$33,328
OTC gross margin percentage	30.5%		29.1%	30.6%		29.3%

The year-over-year increase in cost of sales in our OTC segment in absolute dollars for the three- and six-month periods ended June 29, 2008 resulted from increased order volume and net sales. The year-over-year increase in gross margin percentage in this segment for the three- and six-month periods ended June 29, 2008 resulted primarily from improvements in product margins in a majority of our product categories as a result of our ongoing pricing and sourcing profitability initiatives, and to a lesser extent, a shift in product mix to higher margin product categories.

### Vision Cost of Sales and Gross Margin

	Three Months Ended			Six Months Ended		
	June 29, 2008	% Change (\$ in thousands)	July 1, 2007	June 29, 2008	% Change (\$ in thousands)	July 1, 2007
Vision cost of sales	\$12,238	16.8%	\$10,475	\$24,266	15.7%	\$20,971
<i>Segmented cost of sales information:</i>						
Vision cost gross margin dollars	\$ 3,612		\$ 3,320	\$ 7,020		\$ 6,376
Vision cost gross margin percentage	22.8%		24.1%	22.4%		23.3%

## Table of Contents

The year-over-year increase in cost of sales in our vision segment in absolute dollars for the three- and six-month periods ended June 29, 2008 resulted from increased order volume and net sales. The year-over-year decrease in gross margin percentage in this segment for the three- and six-month periods ended June 29, 2008 resulted primarily from increased promotional offers, which increase the average net sales per order, but had an unfavorable impact on gross margin percentage.

### *Mail-Order Pharmacy Cost of Sales and Gross Margin*

	Three Months Ended			Six Months Ended		
	June 29,	% Change (\$ in thousands)	July 1,	June 29,	% Change (\$ in thousands)	July 1,
	2008		2007	2008		2007
Mail-order pharmacy cost of sales	\$9,342	-10.7%	\$10,466	\$19,484	-10.5%	\$21,779
<i>Segmented cost of sales information:</i>						
Mail-order pharmacy gross margin dollars	\$2,145		\$ 1,985	\$ 4,284		\$ 4,150
Mail-order pharmacy gross margin percentage	18.7%		15.9%	18.0%		16.0%

The year-over-year decrease in cost of sales in our mail-order pharmacy segment in absolute dollars for the three- and six-month periods ended June 29, 2008 resulted from a decrease in order volume and net sales. The year-over-year increase in gross margin percentage in this segment for three- and six-month periods ended June 29, 2008 resulted primarily from a shift in sales mix to higher margin generic drugs compared to lower margin brand name drugs, and our ongoing review of pricing and profitability of pharmaceutical products.

### *Local Pick-up Pharmacy Cost of Sales and Gross Margin*

	Three Months Ended			Six Months Ended		
	June 29,	% Change (\$ in thousands)	July 1,	June 29,	% Change (\$ in thousands)	July 1,
	2008		2007	2008		2007
Local pick-up pharmacy cost of Sales	\$26,629	13.0%	\$23,566	\$51,169	8.5%	\$47,168
<i>Segmented cost of sales information:</i>						
Local pick-up gross margin dollars	\$ 3,910		\$ 3,073	\$ 7,439		\$ 5,944
Local pick-up gross margin Percentages	12.8%		11.5%	12.7%		11.2%

The year-over-year increase in cost of sales in our local pick-up pharmacy segment in absolute dollars in the three- and six-month periods ended June 29, 2008 resulted from an increase in order volume and net sales. The year-over-year increase in gross margin percentage in this segment for the three- and six-month periods ended June 29, 2008 resulted primarily from selling a higher proportion of higher margin generic drugs compared to lower margin brand name drugs.

### *Fulfillment and Order Processing Expenses*

	Three Months Ended			Six Months Ended		
	June 29,	% Change (\$ in thousands)	July 1,	June 29,	% Change (\$ in thousands)	July 1,
	2008		2007	2008		2007
Fulfillment and order processing expenses	\$12,184	14.3%	\$10,656	\$24,334	12.5%	\$21,630
Percentage of net sales	9.9%		9.7%	10.0%		9.8%
<i>Fixed and variable cost information:</i>						
Variable costs	\$ 8,758	11.1%	\$ 7,884	\$17,545	8.9%	\$16,108
Fixed costs	\$ 3,426	23.6%	\$ 2,772	\$ 6,789	22.9%	\$ 5,522

## Table of Contents

Fulfillment and order processing expenses include payroll and related expenses for personnel engaged in purchasing, fulfillment, distribution, and customer care activities (including warehouse personnel and pharmacists engaged in prescription verification activities), distribution center equipment and packaging supplies, per-unit fulfillment fees charged by Rite Aid for prescriptions ordered through the drugstore.com web store and picked up at a Rite Aid store, credit card processing fees, and bad debt expenses. These expenses also include rent and depreciation related to equipment and fixtures in our distribution center and call center facilities. Variable fulfillment costs represent the incremental (variable) costs of fulfilling, processing, and delivering the order that are variable based on sales volume.

Variable fulfillment and order processing expenses increased year-over-year for the three- and six month periods ended June 29, 2008 primarily as a result of an 11% increase in order volume in our OTC segment. Fixed fulfillment and order processing expenses increased for the three- and six month periods ended June 29, 2008 compared to the same periods in 2007, primarily as a result of increased facility related costs of \$244,000 and \$687,000, respectively, resulting from the addition of our inventory storage facility in the second half of 2007, increased depreciation expense of \$229,000 and \$224,000, respectively, related to equipment and software purchases for our primary distribution facility, and increased professional fees of \$315,000 and \$490,000, respectively, related to process improvement projects in our primary distribution facility, partially offset with a decrease in stock-based compensation of \$83,000 and \$173,000, respectively. Fulfillment and order processing expenses as a percentage of net sales increased for the three- and six-month periods ended June 29, 2008 compared to the same periods in 2007, as a result of an increase in fixed costs, partially offset by a year-over-year 100 basis point improvement in variable costs as a percentage of net sales due to increased efficiencies in our primary distribution facility.

### Marketing and Sales Expenses

	Three Months Ended			Six Months Ended		
	June 29,		July 1, 2007	June 29,		July 1, 2007
	2008	% Change (\$ in thousands)		2008	% Change (\$ in thousands)	
Marketing and sales expenses	\$8,821	12.1%	\$7,872	\$17,707	10.9%	\$15,961
Percentage of net sales	7.2%		7.1%	7.3%		7.2%

Marketing and sales expenses include advertising expenses, promotional expenditures, web analytical tools, web design, and payroll and related expenses for personnel engaged in marketing and merchandising activities. Advertising expenses include our obligations under various advertising and service contracts. Advertising and promotional costs were \$6.1 million and \$12.4 million for the three- and six-month periods ended June 29, 2008, respectively, and were \$5.6 million and \$11.1 million for the three- and six-month periods ended July 1, 2007, respectively.

Marketing and sales expenses increased year-over-year both in absolute dollars and as a percentage of net sales for the three- and six-month periods ended June 29, 2008. The year-over-year increase in the three- and six-month periods ended June 29, 2008 resulted primarily from an increase of \$667,000 and \$1.3 million, respectively, in paid search, affiliate, and portal costs, resulting from an increase in order volume, a shift to a higher mix of paid orders compared to free orders, and increased employee related costs of \$231,000 and \$312,000, respectively. Marketing and sales dollars per new customer remained consistent in the second quarter of 2008 at \$23, compared to the second quarter of 2007, but declined in the six-month period ended June 29, 2008 to \$23, from \$24 for the same period in 2007.

### Technology and Content Expenses

	Three Months Ended			Six Months Ended		
	June 29,		July 1, 2007	June 29,		July 1, 2007
	2008	% Change (\$ in thousands)		2008	% Change (\$ in thousands)	
Technology and content expenses	\$5,736	28.2%	\$4,475	\$10,939	19.0%	\$9,190
Percentage of net sales	4.7%		4.1%	4.5%		4.2%

Technology and content expenses consist primarily of payroll and related expenses for personnel engaged in developing, maintaining, and making routine upgrades and improvements to our websites. Technology and content expenses also include Internet access and hosting charges, depreciation on hardware and IT structures, utilities, and website content and design expenses.

## Table of Contents

Technology and content expenses increased year-over-year both in absolute dollars and as a percentage of net sales for the three- and six-month periods ended June 29, 2008. The year-over-year increase in the three- and six-month periods ended June 29, 2008 resulted primarily from an increase in depreciation expense of \$629,000 and \$811,000, respectively, resulting from the completion of internally developed software projects and the acquisition of software and computer equipment to enhance our websites and IT infrastructure, an increase in employee related expenses of \$487,000 and \$759,000, respectively, due to increased headcount, and to a lesser extent, increased other operational costs to support our growth in our IT infrastructure.

### General and Administrative Expenses

	Three Months Ended			Six Months Ended		
	June 29,		July 1,	June 29,		July 1,
	2008	% Change	2007	2008	% Change	2007
	(\$ in thousands)			(\$ in thousands)		
General and administrative expenses	\$4,900	-5.0%	\$5,157	\$10,294	4.3%	\$9,866
Percentage of net sales	4.0%		4.7%	4.2%		4.5%

General and administrative expenses consist of payroll and related expenses for executive and administrative personnel, corporate facility expenses, professional service expenses, and other general corporate expenses.

General and administrative expenses decreased year-over-year both in absolute dollars and as a percentage of net sales for the three-month period ended June 29, 2008, and increased year-over-year in absolute dollars but decreased as a percentage of net sales for the six-month period ended June 29, 2008. The year-over-year decrease in the three-month period ended June 29, 2008 resulted primarily from a decrease in stock-based compensation and other employee related expenses of \$778,000 resulting from certain stock awards being fully amortized in the prior year, partially offset by increased professional expenses of \$486,000 related primarily to consulting projects focused on our profitability initiatives. The year-over-year increase in the six-month period ended June 29, 2008 resulted primarily from an increase of \$1.4 million in professional fees related to our profitability initiatives and an increase of \$234,000 related to estimated uncollected sales taxes and interest incurred prior to the unfavorable ruling on our NJ sales tax case in March 2008. These increases were offset by a decrease in stock-based compensation and employee related expenses of \$1.0 million, resulting from certain stock awards being fully amortized in the prior year and includes a reduction in costs from a non-recurring charge from the first quarter of 2007 of \$190,000 related to the departure of our chief financial officer and the search for his replacement, and a decrease of approximately \$200,000 in insurance and other administrative expenses.

### Amortization of Intangible Assets

	Three Months Ended			Six Months Ended		
	June 29,		July 1,	June 29,		July 1,
	2008	% Change	2007	2008	% Change	2007
	(\$ in thousands)			(\$ in thousands)		
Amortization of intangible assets	\$ 210	-31.4%	\$ 306	\$ 455	-39.3%	\$ 750

Amortization of intangible assets includes the amortization expense associated with assets acquired in connection with our acquisitions of CNS and Acumins, Inc., and assets acquired in connection with our agreements with Rite Aid and GNC, and other intangible assets, including a technology license agreement, domain names, and trademarks.

The year-over-year decrease in amortization expense for three- and six-month periods ended June 29, 2008 resulted from certain intangible assets being fully amortized in 2007 and 2008.

### Interest Income and Expense

	Three Months Ended			Six Months Ended		
	June 29,		July 1,	June 29,		July 1,
	2008	% Change	2007	2008	% Change	2007
	(\$ in thousands)			(\$ in thousands)		
Interest income, net	\$ 100	-71.9%	\$ 356	\$ 379	-53.0%	\$ 806

Interest income consists of earnings on our cash, cash equivalents, and marketable securities, and interest expense consists primarily of interest associated with capital lease and debt obligations. The year-over-year decrease in net interest income for the three- and six-month periods ended June 29, 2008 was a result of receiving lower returns on cash, cash equivalents, and marketable securities balances compared to the same periods in 2007.

## Table of Contents

### *Income Taxes*

There was no provision or benefit for income taxes for the three- and six-month periods ended June 29, 2008 and July 1, 2007 due to our ongoing operating losses.

### **Significant Accounting Judgments**

The preparation of financial statements in conformity with U.S. generally accepted accounting principles, or GAAP, requires estimates and assumptions that affect the reported amounts of assets and liabilities, revenues and expenses, and related disclosures of contingent assets and liabilities in the consolidated financial statements and accompanying notes. The Securities and Exchange Commission, or SEC, has defined a company's critical accounting policies as the ones that are most important to the portrayal of the company's financial condition and results of operations and that require the company to make its most difficult and subjective judgments, often as a result of the need to make estimates of matters that are inherently uncertain. Significant accounting policies are included in Note 1 of our consolidated financial statements included in Part I of our annual report on Form 10-K for the fiscal year ended December 30, 2007. Although we believe that our estimates, assumptions, and judgments are reasonable, they are based on information presently available. Actual results may differ significantly from these estimates under different assumptions, judgments, or conditions. In addition, any significant unanticipated changes in any of our assumptions could have a material adverse effect on our business, financial condition, and results of operations.

### **Off-Balance Sheet Transactions**

We have not entered into any off-balance sheet transactions.

### **Liquidity and Capital Resources**

We have incurred net losses of \$766.8 million since inception. To date, we have not been profitable, and we may never achieve profitability on a full-year or consistent basis. We expect to continue to incur net losses in the third quarter of 2008, and possibly longer. As a result, our stock price may decline and stockholders may lose all or a part of their investment in our common stock. From our inception through June 29, 2008, we have financed our operations primarily through the sale of equity securities, including common and preferred stock, yielding net cash proceeds of \$421.1 million.

### *Discussion of Cash Flows*

The following table provides information regarding our cash flows for the six-month periods ended June 29, 2008 and July 1, 2007.

	Six Months Ended		
	June 29, 2008	\$ Change (in thousands)	July 1, 2007
Cash provided by operating activities	\$ 4,400	\$ 1,808	\$ 2,592
Cash used in investing activities	(\$9,362)	(\$3,596)	(\$5,766)
Cash provided by financing activities	\$ 2,705	\$ 1,867	\$ 838
Net decrease in cash and cash equivalents	(\$2,257)	\$ 79	(\$2,336)

Net cash provided by operating activities for the six-month period ended June 29, 2008 was \$4.4 million, and reflected a net loss of \$5.0 million, offset by adjustments for non-cash expenses consisting of depreciation and amortization of \$6.5 million and stock-based compensation of \$3.9 million. In addition, accounts receivable increased \$3.6 million, prepaid marketing expenses and other current assets decreased \$796,000, and accounts payable, accrued expenses, and other liabilities increased \$1.8 million. These sources and uses of cash are primarily due to the timing of cash receipts and payments. Net cash used in operating activities for the six-month period ended July 1, 2007 was \$2.6 million, and reflected a net loss of \$6.8 million, offset by adjustments for non-cash expenses consisting of depreciation and amortization of \$5.7 million and stock-based compensation of \$5.0 million. In addition, inventories decreased \$1.0 million, prepaid marketing expenses and other current assets increased by \$225,000, accounts receivable decreased \$426,000 and accounts payable, accrued expenses, and other liabilities decreased \$2.5 million. These sources and uses of cash are primarily due to the timing of cash receipts and payments.

---

## Table of Contents

Net cash used in investing activities for the six-month periods ended June 29, 2008 and July 1, 2007 are primarily attributable to the purchase of marketable securities and the acquisition of fixed assets, offset by the sales and maturities of marketable securities. Cash used in investing activities increased year-over-year as a result of an increase in the acquisition of fixed assets of \$3.0 million and purchases of marketable securities of \$16.2 million offset by the sales and maturities of marketable securities of \$15.6 million

Net cash provided by financing activities for the six-month period ended June 29, 2008 was attributable to borrowings under our revolving bank line of credit of \$3.5 million and proceeds received from exercises of employee stock options and purchases under our employee stock purchase plan of \$423,000, partially offset by the repayment of debt obligations of \$1.2 million. Net cash used by financing activities for the six-month period ended July 1, 2007 was attributable to proceeds received from exercises of employee stock options and purchases under our employee stock purchase plan of \$1.9 million and borrowings under our revolving bank line of credit of \$300,000, partially offset by the repayment of debt obligations of \$1.4 million. Cash provided by financing activities increased year-over-year primarily as a result of increased borrowings under our revolving bank line of credit, partially offset by lower proceeds received from the exercise of employee stock options and purchases under our employee stock purchase plan.

Until required for other purposes, our cash and cash equivalents are maintained in deposit accounts or highly liquid investments with remaining maturities of 90 days or less at the time of purchase. Our marketable securities, which include corporate notes and bonds and U.S. government agency obligations, are considered short-term as they are available to fund current operations.

### *Liquidity Sources, Requirements and Contractual Cash Requirements and Commitments*

Our principal sources of liquidity are our cash, cash equivalents, and marketable securities. Historically, our principal liquidity requirements have been to meet our working capital and capital expenditure needs.

Our primary source of cash is sales made through our web stores, for which we collect cash from credit card settlements or insurance reimbursements. Our primary uses of cash are purchases of inventory, salaries, marketing expenses, and overhead and fixed costs. Any projections of our future cash needs and cash flows are subject to substantial uncertainty for the reasons discussed in the sections entitled “*Risk Factors*” in Part II, Item 1A of this quarterly report and Part I, Item 1A of our annual report on Form 10-K for the year ended December 30, 2007.

In March 2008, we entered into an amended and restated loan and security agreement with our existing bank. This agreement includes a revolving line of credit allowing for borrowings of up to \$10.0 million, which accrue interest at the prime rate. The revolving line of credit matures in March 2009. The agreement allows for the conversion of up to \$5.0 million of the outstanding balance into a term loan within 60 days of maturity. In March 2008, borrowings under the existing line of credit totaling \$5.0 million and existing term loans totaling \$972,222 were converted into one term loan totaling \$6.0 million under the amended and restated loan and security agreement. The term loan is payable in 36 monthly installments and accrues interest at the prime rate plus .50% (5.50% at June 29, 2008). The balance outstanding under the term loan totaled \$5.5 million as of June 29, 2008.

As of June 29, 2008 we did not have any future material noncancelable commitments to purchase goods or services.

We believe that our cash and marketable securities on hand plus our sources of cash will be sufficient to fund our operations and anticipated capital expenditures. However, any projections about our future cash needs and cash flows are subject to substantial uncertainty. As a result, we may need to raise additional monies to fund our operating activities or for strategic flexibility (if, for example, we decide to pursue business or technology acquisitions) or if our expectations regarding our operations and anticipated capital expenditures change. We have assessed in the past, and will continue to assess, opportunities for raising additional funds by selling equity, equity-related or debt securities, obtaining additional credit facilities, or obtaining other means of financing for strategic reasons or to further strengthen our financial position. We cannot be certain that additional financing will be available to us on acceptable terms when required, or at all. Furthermore, if we were to raise additional funds through the issuance of securities, such securities may have rights, preferences, or privileges senior to those of the rights of our common stock and our stockholders may experience additional dilution.

### **Management Outlook**

For the third quarter of fiscal year 2008, we are targeting net sales in the range of \$118.0 million to \$122.0 million and a net loss in the range of \$1.0 million to \$2.0 million.

---

## Table of Contents

### **Item 3. Quantitative and Qualitative Disclosures about Market Risk**

We have assessed our vulnerability to certain market risks, including interest rate risk associated with marketable securities, accounts receivable, accounts payable, capital lease obligations, and cash and cash equivalents. Due to the short-term nature of these investments and our investment policies and procedures, we have determined that the risk associated with interest rate fluctuations related to these financial instruments is not material to us.

We have interest rate exposure arising from our financing facilities, which have variable rates. These variable interest rates are affected by changes in short-term interest rates. We manage our interest rate exposure by maintaining a conservative debt-to-equity ratio. We believe that the effect, if any, of reasonably possible near-term changes in interest rates on our financial position, results of operations, and cash flows will not be material. Our financing facilities expose our net earnings to changes in short-term interest rates because interest rates on the underlying obligations are variable. Borrowings outstanding under the variable interest-bearing financing facilities totaled \$5.5 million at June 29, 2008, and the highest interest rate attributable to this outstanding balance was 5.50% at June 29, 2008. A change in net earnings resulting from a hypothetical 10% increase or decrease in interest rates would not be material.

We have investment risk exposure arising from our investments in marketable securities. As of June 29, 2008, we had \$18.9 million of securities classified as “marketable securities.” We regularly review the carrying value of our investments and identify and record losses when events and circumstances indicate that declines in the fair value of such assets below our accounting basis are other-than-temporary.

### **Item 4. Controls and Procedures**

Under the supervision of and with the participation of our management, including our chief executive officer and chief accounting officer, we performed an evaluation of the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended, or the Exchange Act). Based on that evaluation, our management, including our chief executive officer and chief accounting officer, concluded that, as of June 29, 2008, our disclosure controls and procedures were effective to provide reasonable assurance that all material information required to be disclosed in reports filed or submitted by us under the Exchange Act is made known to management in a timely fashion.

On May 5, 2008, Thère du Pont, our Senior Vice President of Operations and Chief Financial Officer resigned effective May 29, 2008, and the Company promoted Tracy Wright to Chief Finance Officer and Robert Potter to Chief Accounting Officer to fill Mr. du Pont’s role as CFO. Management has taken and is taking the necessary steps to monitor and maintain the appropriate level of internal controls during this transition period, and does not believe that there have been any material adverse impacts to our internal controls over financial reporting.

The certifications required by Section 302 of the Sarbanes-Oxley Act of 2002 are filed as exhibits 31.1 and 31.2, respectively, in this Form 10-Q.

PART II—OTHER INFORMATION

**Item 1. Legal Proceedings**

See Note 7 of our consolidated financial statements, “*Commitments and Contingencies—Legal Proceedings*,” included in Part I, Item 1 of this quarterly report, for a discussion of the material legal proceedings to which we are a party.

**Item 1A. Risk Factors**

The risk factor disclosure included under Item 1A of our Annual Report on Form 10-K for the fiscal year end December 30, 2007, filed with the Securities and Exchange Commission on March 14, 2008 (the “Form 10-K”) has not materially changed other than as set forth below.

***We have a history of generating significant losses, and may never be profitable.***

We have incurred net losses of \$766.8 million through June 29, 2008. To date, we have not become profitable, and we may never achieve profitability on a full-year or consistent basis. We expect to continue to incur net losses in the third quarter of 2008, and possibly longer. As a result, our stock price may decline and stockholders may lose all or a part of their investment in our common stock.

***Our relationship with Rite Aid involves many risks and restricts our ability to promote, contract with, or operate traditional retail stores.***

In June 1999, we entered into a series of agreements with Rite Aid that expire in June 2009. These agreements involve many aspects of our respective businesses and the operation of our respective websites, the fulfillment of orders, and the extension of Rite Aid’s insurance relationships to cover prescriptions processed by us. We are currently in discussions with Rite Aid regarding the nature of any future relationship with them.

Our Rite Aid agreements benefit both our local pick-up and mail-order pharmacy segments, which together comprised approximately 35% of our net sales in fiscal 2007 and 34% of our net sales for the six months ended June 29, 2008. Our local pick-up pharmacy segment, under which our customers can pick up prescriptions at any Rite Aid store, depends on our relationship with Rite-Aid. If our ability to offer customers a local pick-up option were adversely affected by changes in Rite-Aid’s operations or in our relationship with Rite-Aid, our ability to generate revenue from local pick-up pharmacy sales would be reduced or eliminated. This could occur, for example, if we are unable to renew our arrangement with Rite Aid or establish a relationship with another company to offer local pick-up of prescriptions, or if Rite Aid were to close a significant number of its stores. The loss of our local pick-up sales, which comprised approximately 24% of our net sales in fiscal 2007 and 24% of our net sales for the six months ended June 29, 2008, would greatly reduce our revenue and harm our business.

In addition, we currently use Rite Aid’s systems to process prescription orders in our mail-order pharmacy segment. If we were unable to maintain our relationship with Rite Aid and could not feasibly implement an alternative method for processing prescriptions, through either our own systems or those of a third party, we would be unable to maintain our mail-order pharmacy operations. The loss of our mail-order pharmacy sales would significantly reduce our revenue and harm our business.

Our arrangement with Rite Aid is complex and requires substantial effort and attention to operate and manage successfully. We may not be able to accommodate changes that Rite Aid may make to its systems that we use, which may limit our ability to operate our business.

While Rite Aid has committed to promoting drugstore.com in its stores and in its advertising, we do not control the choice of ads in which we are featured, and this form of advertising may not result in additional drugstore.com customers. In addition, a substantial alteration of Rite Aid’s marketing efforts, or a breach by Rite Aid of its marketing obligations, could adversely affect our revenues and harm our business. While our relationship with Rite Aid substantially broadens our ability to provide prescription medications to consumers with insurance reimbursement plans, it may not allow all of our potential customers to purchase these medications from drugstore.com and receive insurance reimbursement, which could adversely affect consumer perceptions of us and our revenues. In addition, our relationship with Rite Aid contains limitations on the scope of our activities, including restrictions on our ability to promote, contract with, or operate traditional retail stores, and the prohibition on our ability to become a PBM. We have also agreed not to contract with another traditional retail store to fill pharmacy product orders we receive unless a Rite Aid store is not conveniently located near a customer. These restrictions could limit our flexibility and ability to grow our business if our relationship with Rite Aid is not successful.

***Changes in our senior management may have an adverse effect on our ability to execute our business strategy.***

Our success depends largely on the efforts and abilities of our senior management to execute our business plan. Changes in our senior management have been, and future changes may be, disruptive to our business and may adversely affect our operations. For example, changes in senior management positions could adversely affect our ability to execute our existing business strategies or plans or cause us to adopt less successful business strategies or plans than we are currently pursuing. Our business could suffer as a result.

The information above updates and should be read in conjunction with the discussion of our risk factors contained in Item 1A of the Form 10-K.

## Table of Contents

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

On June 27, 2008, we issued to certain consultants a fully vested warrant to purchase 50,000 shares of our common stock at \$2.53 per share, expiring in June 2018, in conjunction with the performance of services under a consulting agreement. The issuance of these warrants was exempt from registration under the Securities Act of 1933, as amended, as a private offering under Section 4(2) of the Securities Act.

### **Item 3. Defaults Upon Senior Securities.**

None.

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

We held our annual meeting of stockholders on June 12, 2008, where our stockholders voted on the following matters:

Proposal 1: Our stockholders re-elected the following directors:

<u>Nominee</u>	<u>Votes For</u>	<u>Votes Withheld</u>
Dawn G. Lepore	77,299,634	2,128,167
Richard W. Bennet III	77,708,201	1,719,600
Geoffrey R. Entress	77,703,881	1,723,920
Jeffrey M. Killeen	76,618,530	2,809,271
William D. Savoy	75,945,995	3,481,806
Gregory S. Stanger	77,231,174	2,196,627

Proposal 2: Our stockholders approved our 2008 Equity Incentive Plan, with 49,213,242 votes for, 10,060,031 votes against, 159,122 abstentions, and 19,995,406 broker non-votes.

Proposal 3: Our stockholders approved proposed Amendments to our Certificate of Incorporation and authorized our board of directors to effect a reverse stock split, with 65,969,554 votes for, 11,809,798 votes against, and 1,648,449 abstentions.

Proposal 4: Our stockholders ratified the appointment of Ernst & Young LLP to serve as our independent registered public accounting firm for fiscal year 2008, with 78,718,761 votes for, 502,490 against and 206,550 abstentions.

### **Item 5. Other Information.**

None.

### **Item 6. Exhibits**

<u>Exhibit No.</u>	<u>Exhibit Description</u>
3.1	Amended and Restated Certificate of Incorporation of drugstore.com, inc. (incorporated by reference to Exhibit 3.2 to drugstore.com, inc.'s Registration Statement on Form S-1 filed February 9, 2000 (Registration No. 333-96441)).
3.1a	Certificate of Designation of Series 1 Preferred Stock of drugstore.com, inc. (incorporated by reference to Exhibit 3.1a to drugstore.com, inc.'s Quarterly Report on Form 10-Q for the Quarter Ended July 2, 2000 (SEC File No. 000-26137)).
3.2	Amended and Restated Bylaws of drugstore.com, inc. dated January 7, 2005 (incorporated by reference to Exhibit 3.2 to drugstore.com inc.'s Annual Report on Form 10-K for the Fiscal Year Ended January 1, 2006 (SEC File No. 000-26137)).
10.1	Amendment to the Main agreement between drugstore.com, inc. and Rite Aid Corporation dated April 30, 2008 (incorporated by reference to Exhibit 10.1 to drugstore.com, inc.'s Current Report on Form 8-K dated April 30, 2008 (SEC File No. 000-26137)).
31.1*	Certification of Dawn G. Lepore, Chairman of Board, President and Chief Executive Officer of drugstore.com, inc., pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2*	Certification of Robert P. Potter, Vice President and Chief Accounting Officer of drugstore.com, inc., pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1*	Certification of Dawn G. Lepore, Chairman of Board, President and Chief Executive Officer of drugstore.com, inc., pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2*	Certification of Robert P. Potter, Vice President and Chief Accounting Officer of drugstore.com, inc., pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

\* Filed herewith

**SIGNATURES**

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

DRUGSTORE.COM, INC.  
(Registrant)

By: /s/ Robert P. Potter  
Robert P. Potter  
*Vice President and Chief Accounting Officer*

Date: August 8, 2008

## CERTIFICATIONS

I, Dawn G. Lepore, certify that:

1. I have reviewed this quarterly report on Form 10-Q of the registrant, drugstore.com, inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors:
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

August 8, 2008

/s/ Dawn G. Lepore

President, Chief Executive Officer and  
Chairman of the Board

## CERTIFICATIONS

I, Robert P. Potter, certify that:

1. I have reviewed this quarterly report on Form 10-Q of the registrant, drugstore.com, inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors:
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

August 8, 2008

/s/ Robert P. Potter

Vice President and Chief Accounting Officer

**CERTIFICATION PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report of drugstore.com, inc. (the "Company") for the period ending June 29, 2008, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Dawn G. Lepore, President, Chief Executive Officer and Chairman of the Board of the Company, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to §906 of the Sarbanes-Oxley Act of 2002, that:

(1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ Dawn G. Lepore

President, Chief Executive Officer and  
Chairman of the Board

August 8, 2008

A signed original of this written statement required by Section 906 has been provided to drugstore.com, inc. and will be retained by drugstore.com, inc. and furnished to the Securities and Exchange Commission or its staff upon request.

**CERTIFICATION PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report of drugstore.com, inc. (the "Company") for the period ending June 29, 2008, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Robert P. Potter, Vice President and Chief Accounting Officer, of the Company, certify, pursuant to 18 U.S.C. § 1350, as adopted pursuant to §906 of the Sarbanes-Oxley Act of 2002, that:

(1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ Robert P. Potter

Vice President and Chief Accounting Officer

August 8, 2008

A signed original of this written statement required by Section 906 has been provided to drugstore.com, inc. and will be retained by drugstore.com, inc. and furnished to the Securities and Exchange Commission or its staff upon request.