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IAB Internet Advertising Revenue Report

An Industry Survey Conducted by PricewaterhouseCoopers and Sponsored by the Interactive Advertising Bureau (IAB)

2005 Full-Year Results

April 2006

Interactive Advertising Bureau

PricewaterhouseCoopers LLP

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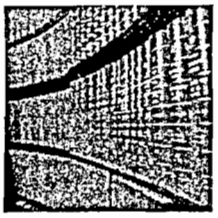

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Background

About the IAB Internet Advertising Revenue Report

Conducted by the New Media Group of PricewaterhouseCoopers LLP on an ongoing basis, with results released quarterly, the "Internet Advertising Revenue Report" was initiated by the Interactive Advertising Bureau (IAB) in 1996. This report aggregates data and information reported directly to PricewaterhouseCoopers LLP by companies representing thousands of Web sites, in addition to other on-line ad selling companies.

The results reported are the most accurate measurement of Internet/on-line advertising revenues since the data is compiled directly from information supplied by companies selling advertising on-line. All-inclusive, the report includes data reflecting on-line advertising revenues from Web sites, commercial on-line services, e-mail providers, as well as other companies selling on-line advertising.

The report is conducted independently by PricewaterhouseCoopers LLP on behalf of the IAB, and only aggregate results are published. Individual company information is held in strict confidence with PricewaterhouseCoopers LLP. Further details regarding scope and methodology are provided in the appendix to this report.

David Silverman
Partner, PricewaterhouseCoopers LLP

Pete Petrusky
Director, PricewaterhouseCoopers LLP

Executive Summary

IAB Internet Advertising Revenue Report
2005 Full-Year Highlights

Internet advertising revenues ("revenues") in the United States totaled over $12.5 billion for the full year 2005, with Q3 accounting for $3.2 billion and Q4 totaling $3.6 billion. Internet advertising revenues for the full year of 2005 increased 30 percent over 2004.

Key trends underlying 2005 results:

- For the third consecutive year, revenues post record results –Total revenues for the 2005 fourth quarter increased 15 percent from the 2005 third-quarter total of $3.2 billion, and 34 percent from the 2004 fourth-quarter total of $2.7 billion. Full year 2005 Internet advertising revenues totaled over $12.5 billion, up just over 30 percent versus full year 2004.

  "Interactive Advertising continues to experience tremendous growth as marketers experience its overall effectiveness in building brands and delivering online and offline sales. We are confident that this growth trend will continue as more marketers find Interactive to be an imperative and additional platforms including broadband video, gaming, and iPTV and others continue to emerge as real opportunities."

  – Greg Stuart, IAB President and CEO

- Search and Display are the leading advertising formats - Search revenue accounted for 41 percent of full year 2005 revenues, up slightly from the 40 percent of 2004 revenues. Display advertising also increased from 19 percent of 2004 revenues to 21 percent of 2005 revenues. Classifieds revenue totaled 17 percent of 2005 full year revenues, down slightly from the 18 percent reported for the full year 2004.

  "The Internet continues to be a vibrant and ever-changing channel, providing advertisers with broad offerings that enable them to promote their brands using a highly cost effective platform. This year's record figure of annual internet advertising revenue demonstrates the enduring enthusiasm for the medium as a whole."

  – David Silverman, Partner, PricewaterhouseCoopers LLP

- Retail Advertisers Drive Consumer Ad Spending - Consumer advertisers continue to represent the largest category of advertiser spending at 51 percent of full year 2005 revenues, up from 49 percent for full year 2004. Within the consumer category the significant sub-categories reported are retail (47 percent of the consumer category), automotive (20 percent), leisure (14 percent) and entertainment (10 percent).

  "Continued strong growth in online advertising documents that an increasing number of advertisers and marketers see the Internet as an essential brand-building component in their media planning. The Internet delivers the right audience at the right time - a winning combination for all types of marketers. We expect to see continued growth in Internet advertising spend."

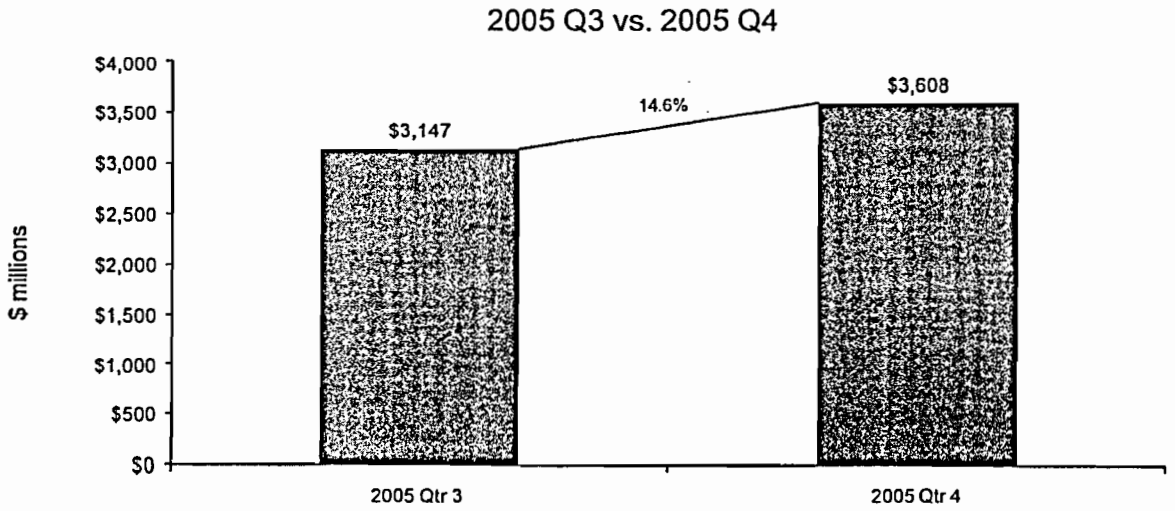
  – Pete Petrusky, Director, PricewaterhouseCoopers LLP

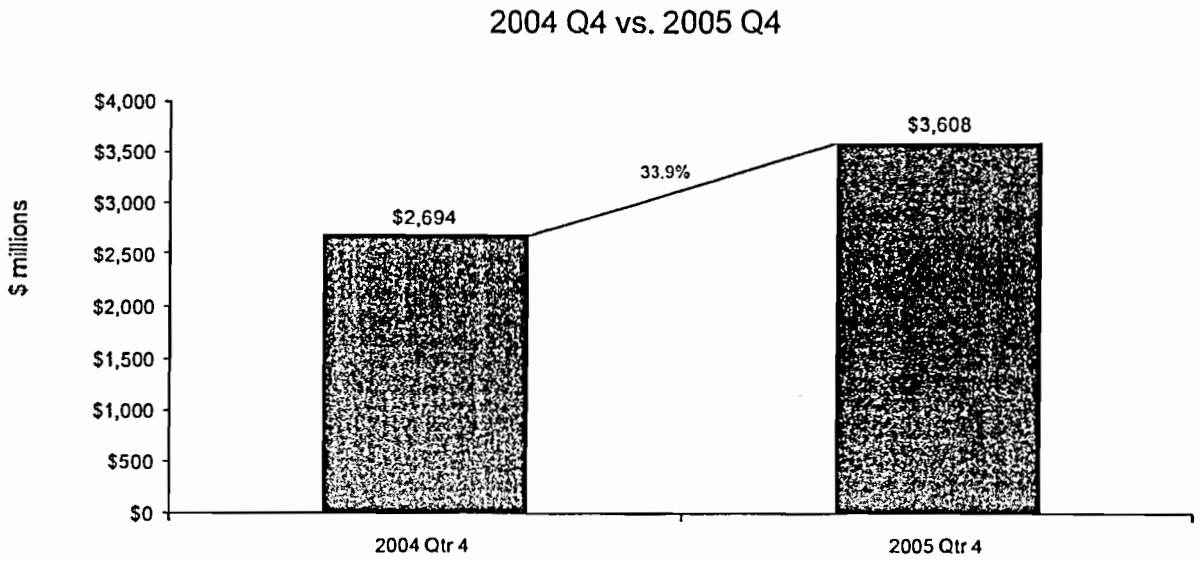
- Internet Continues to Gain Market Share – Internet advertising accounted for nearly 5 percent of total U.S. advertising revenues in 2005, up from less than 4 percent reported in 2004. Internet advertising exceeded advertising for business magazines by more than 50 percent in 2005, and nearly matches total consumer magazine advertising. Adjusted for inflation, Internet advertising revenue significantly outpaced both cable and broadcast television in comparable early growth periods.

Detailed Findings

Revenues Totaled $3.6 Billion in the Fourth Quarter of 2005

- On-line ad sellers reported aggregate revenues totaling $3.6 billion for the fourth quarter of 2005.
- Total 2005 fourth-quarter revenues were $913 million or 33.9 percent higher than the fourth quarter of 2004, and $461 million or 14.6 percent higher than the third quarter of 2005.

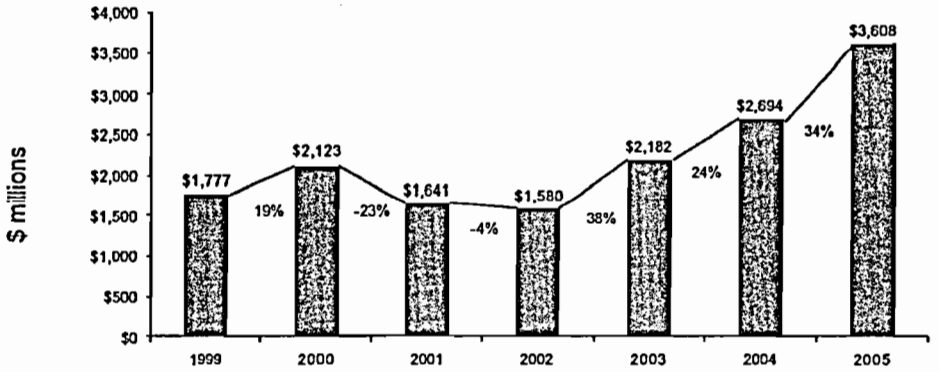




Historical Fourth-Quarter Revenue Trends

- Fourth-quarter revenues increased significantly on a year-over-year percentage and dollar basis since 1996 through the second quarter of 2000, declined during 2001 and 2002, and rebounded the past three years.

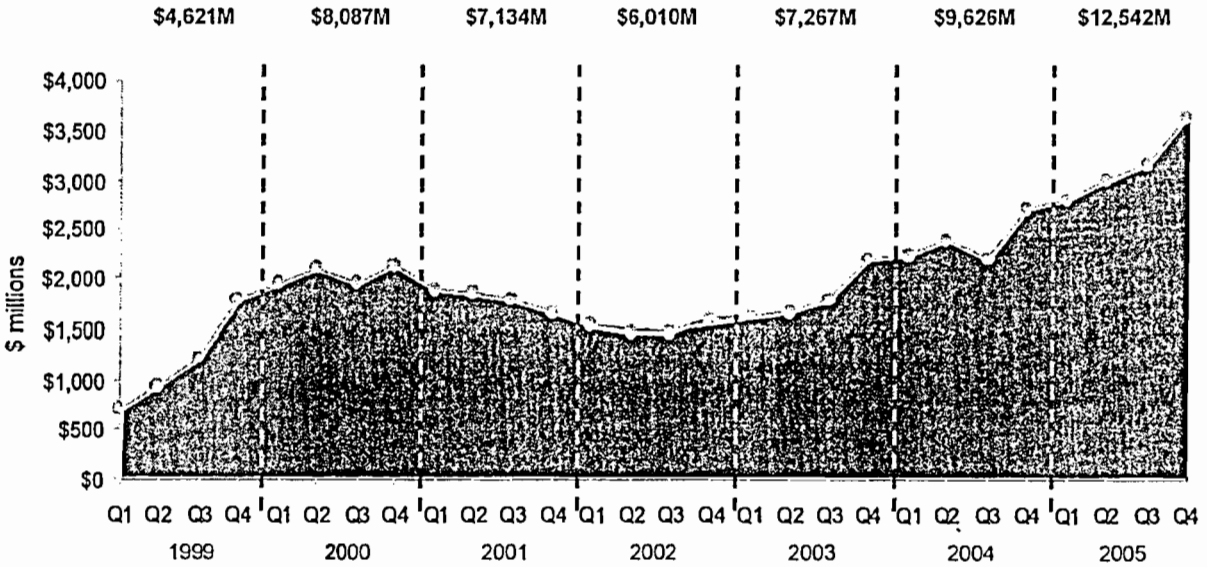
Fourth-Quarter $ Revenue – 1999 through 2005



Quarterly Revenues Post Record Levels

- Quarterly industry revenues posted consistent growth from 1996 to the second quarter of 2000 and peaked in the fourth quarter of 2000.
- Industry revenues subsequently began a period of decline from the fourth quarter of 2000 through the second quarter of 2002. Since the third quarter 2002 revenues have increased 12 of the past 13 consecutive quarters.

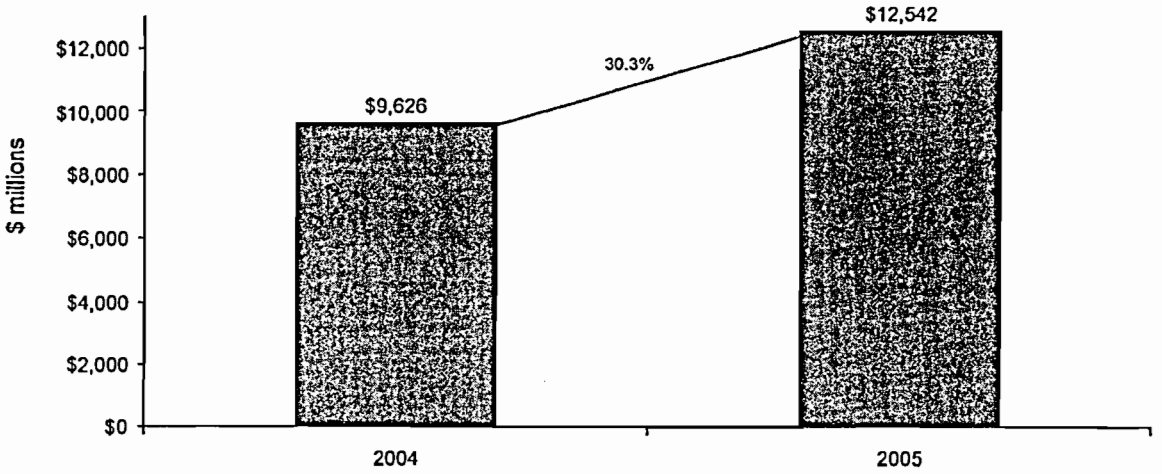
Quarterly $ Revenue Growth Comparisons – 1999 through 2005



2005 Annual Revenues Totaled $12.5 Billion

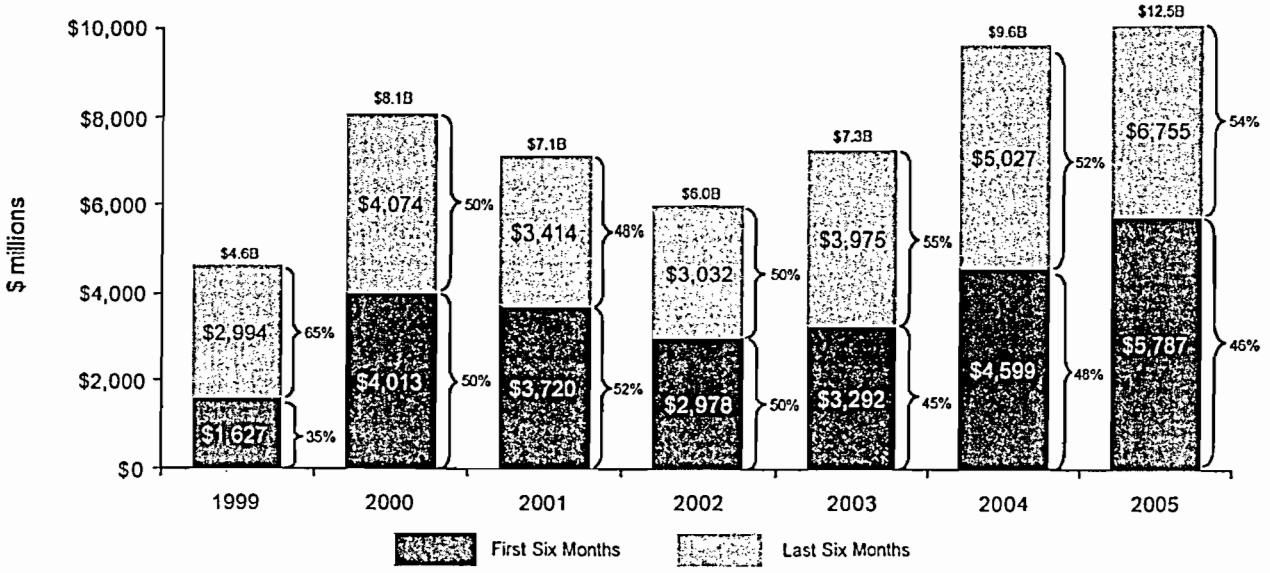
- Full-year revenues for 2005 totaled a record $12.5 billion, $2.9 billion or 30.3 percent higher than the previous record revenues reported for 2004 full-year.

Full-Year Revenues 2004 vs. 2005



- Since 2003 revenues for the second half of the year have accounted for more than 50 percent of the total year revenues.

Historical Revenue Mix – First Half vs. Second Half



Historical Revenue Statistics

Annual and Quarterly Revenue Growth Comparisons

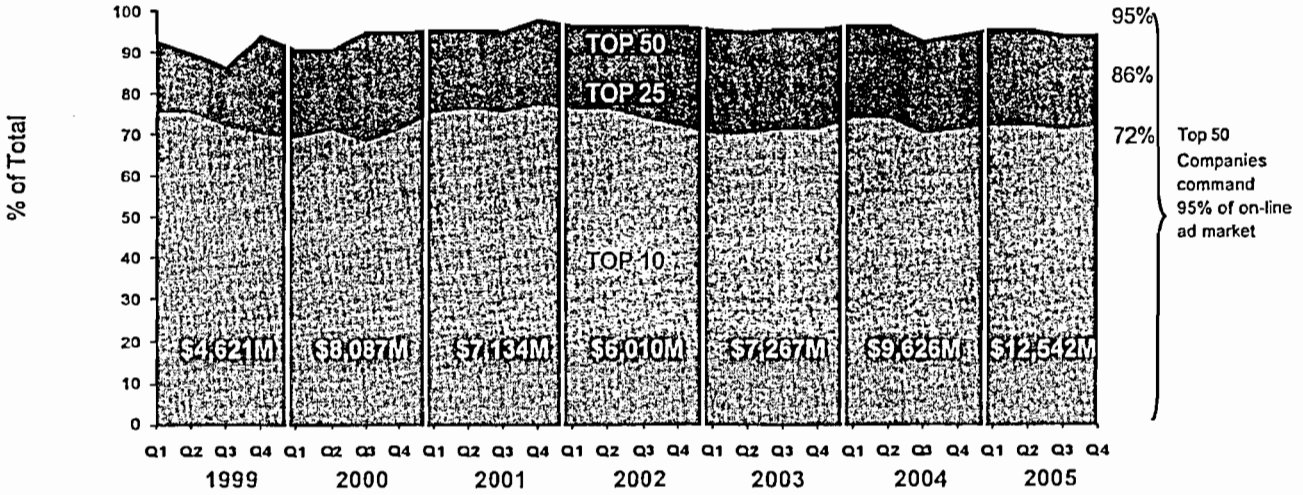
	$ Rev Millions	% GROWTH Qtr/Qtr	% GROWTH Year/Year
1Q96	$30	NA	
2Q96	$52	74%	
3Q96	$76	46%	
4Q96	$110	45%	
Total 1996	$267		
1Q97	$130	18%	333%
2Q97	$214	66%	313%
3Q97	$227	6%	200%
4Q97	$336	48%	205%
Total 1997	$907		239%
1Q98	$351	5%	171%
2Q98	$423	20%	97%
3Q98	$491	16%	116%
4Q98	$656	34%	95%
Total 1998	$1,920		112%
1Q99	$693	6%	97%
2Q99	$934	35%	121%
3Q99	$1,217	30%	148%
4Q99	$1,777	46%	171%
Total 1999	$4,621		141%
1Q00	$1,922	8%	177%
2Q00	$2,091	9%	123%
3Q00	$1,951	-7%	60%
4Q00	$2,123	9%	19%
Total 2000	$8,087		75%

	$ Rev Millions	% GROWTH Qtr/Qtr	% GROWTH Year/Year
1Q01	$1,872	-12%	-3%
2Q01	$1,848	-1%	-12%
3Q01	$1,773	-4%	-10%
4Q01	$1,641	-7%	-23%
Total 2001	$7,134		-12%
1Q02	$1,520	-7%	-19%
2Q02	$1,458	-4%	-21%
3Q02	$1,451	-1%	-18%
4Q02	$1,580	9%	-4%
Total 2002	$6,010		-16%
1Q03	$1,632	3%	7%
2Q03	$1,660	2%	14%
3Q03	$1,793	8%	24%
4Q03	$2,182	22%	38%
Total 2003	$7,267		21%
1Q04	$2,230	2%	37%
2Q04	$2,369	6%	43%
3Q04	$2,333	-2%	30%
4Q04	$2,694	15%	24%
Total 2004	$9,626		33%
1Q05	$2,802	4%	25%
2Q05	$2,985	7%	26%
3Q05	$3,147	5%	35%
4Q05	$3,608	15%	34%
Total 2005	$12,542		30%

Industry Revenue Concentration Remains High

- On-line advertising remains concentrated with the ten leading ad-selling companies, which accounted for 72 percent of total revenues in the fourth quarter of 2005, up from 71 percent reported for the fourth quarter of 2004.
- Companies ranked 11th to 25th accounted for 14 percent of revenues for the fourth quarter of 2005. Companies ranked 26th to 50th accounted for 10 percent in the fourth quarter of 2005.

% Share of total revenues 1999 through 2005

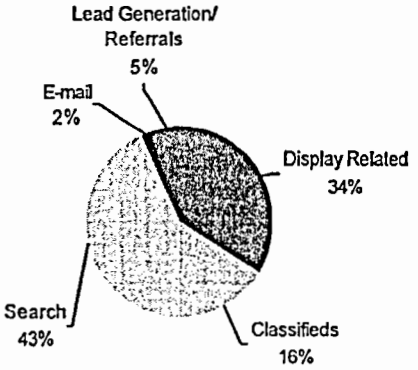


Search and Display Lead All Advertising Formats

- Search remains the largest revenue format, accounting for 43 percent of 2005 fourth-quarter revenues, up from the 40 percent reported for the same quarter in 2004. Search advertising revenues totaled nearly $1.6 billion in the fourth quarter of 2005, up 44 percent from the fourth quarter of 2004, when search revenues totaled approximately $1.1 billion. Search revenues totaled $5.1 billion or 41% of 2005 total revenues, up from $3.8 billion reported in 2004.
- Display Related advertising accounted for $1.2 billion or 34 percent of the total revenues during the fourth quarter of 2005, compared to the $1.0 billion (37 percent of total) reported in 2004 fourth quarter. Display Related advertising includes Display ads (21% of 2005 Q4 revenues), Rich Media (8%), Sponsorship (4%), Slotting Fees (1%). Display Related Advertising revenues totaled $4.3 billion or 34 percent of total 2005 revenues, compared to $3.8 billion (39 percent of total) reported for the same period in 2004.
- Classifieds revenue accounted for 16 percent of 2005 fourth-quarter revenues or $577 million, down slightly from the 18 percent reported in the fourth quarter of 2004. Full year 2005 Classifieds revenue totaled $2.1 billion or 17 percent of total revenues.

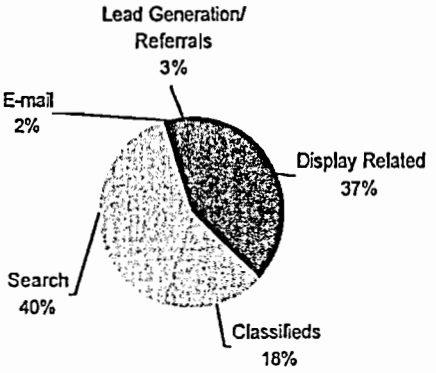
Internet Ad Revenues by Advertising Vehicle

% of 2005 Fourth-Quarter Revenues



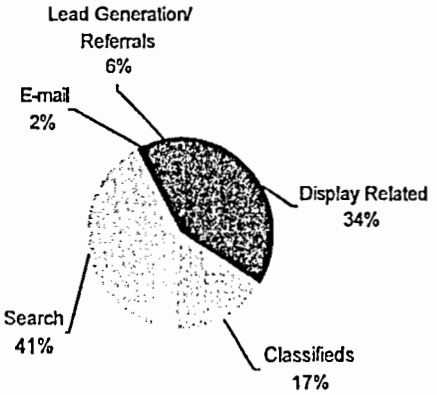
Total – $3.6 Billion

% of 2004 Fourth-Quarter Revenues



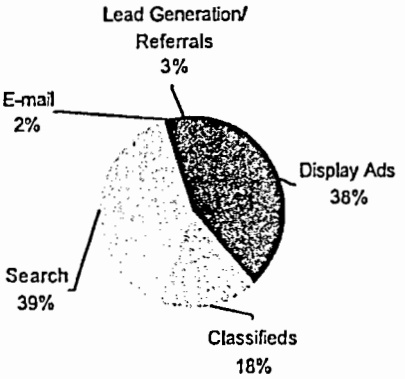
Total – $2.7 Billion

% of 2005 Full-Year Revenues



Total – $12.5 Billion

% of 2004 Full-Year Revenues



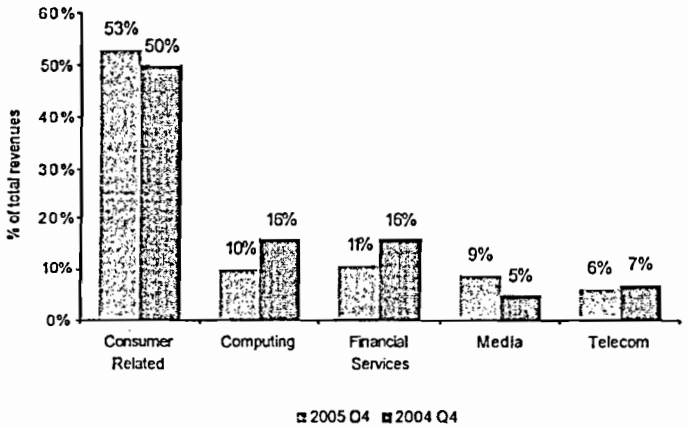
Total – $9.6 Billion

Retail Advertisers Continues to Drive Consumer Ad Spending

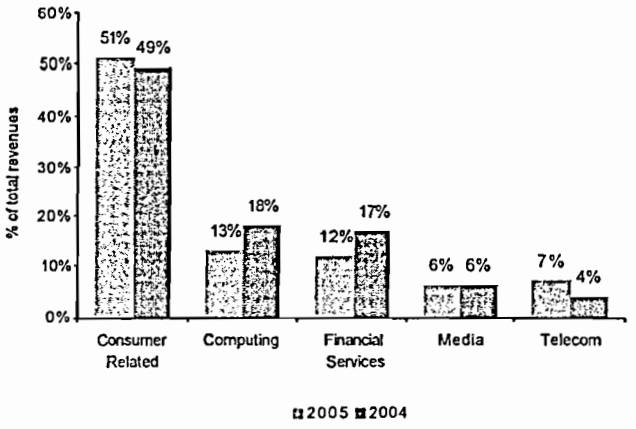
- Consumer advertisers continue to represent the largest category of Internet ad spending, accounting for 51 percent of 2005 full year revenues or $6.4 billion, up slightly from the 49 percent reported for the same period in 2004.
- Financial Services advertisers represented the second-largest category of spending at 12 percent of 2005 full year revenues or $1.5 billion, compared to the 17 percent reported in the same period in 2004.
- Computing advertisers represented the third-largest category of spending at 13 percent of 2005 full year revenues or $1.6 billion, down from the 18 percent reported for full year 2004.
- Telecom companies accounted for 7 percent of full year 2005 revenues or $0.8 billion, up from the 4 percent reported in the same period in 2004, while Media remained consistent at 6% or $0.7 billion of 2005 revenues.
- The consumer related categories are Retail at 47 percent of 2005 full-year consumer ad revenues, followed by Automotive at 20 percent, Leisure (travel, hotel & hospitality) at 14 percent, Entertainment (music, film & TV entertainment) at 10 percent, and Packaged Goods at 5 percent.

Internet Ad Revenues by Major Industry Category*

2005 Q4 vs. 2004 Q4

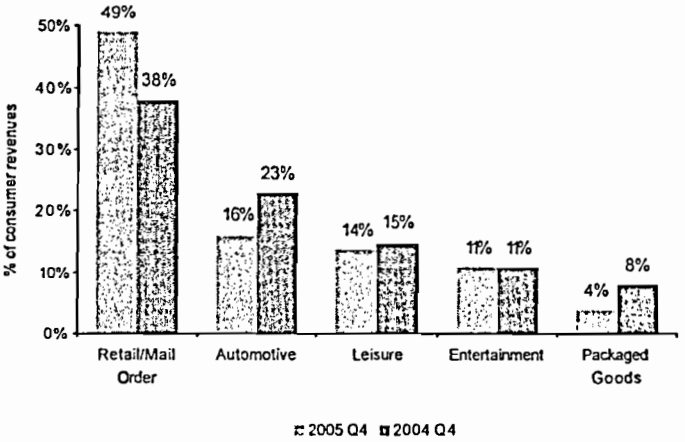


2005 Full Year vs. 2004 Full Year

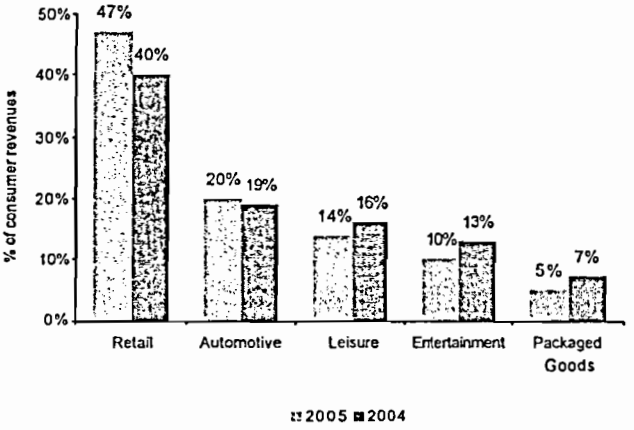


Internet Ad Revenues by Major Consumer Category*

2005 Q4 vs. 2004 Q4



2005 Full Year vs. 2004 Full Year



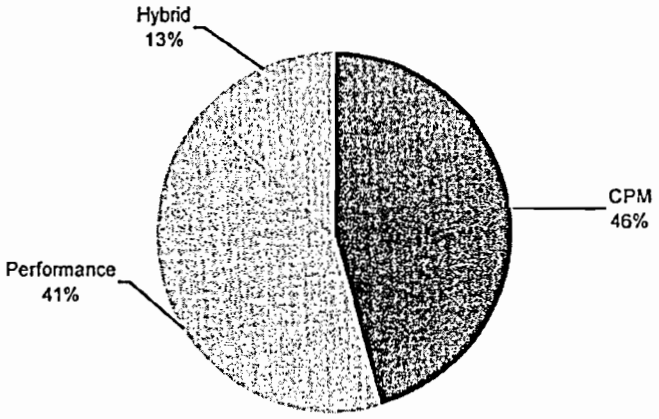
*Categories listed represent the top five ranked by revenue, and may not add up to 100 percent.

Impression-Based Pricing Rebounds

- Survey participants reported 46 percent of 2005 fourth-quarter revenues were priced on a CPM or impression basis (includes sponsorships), up from 38 percent reported for the fourth quarter of 2004.
- Approximately 41 percent of 2005 fourth-quarter revenues were priced on a performance basis (e.g., cost-per-click, sale, lead or straight revenue share), down from 46 percent for the same quarter in 2004.
- Approximately 13 percent of 2005 fourth-quarter revenues were priced on a hybrid basis, increasing from the 16 percent reported for the same quarter in 2004.

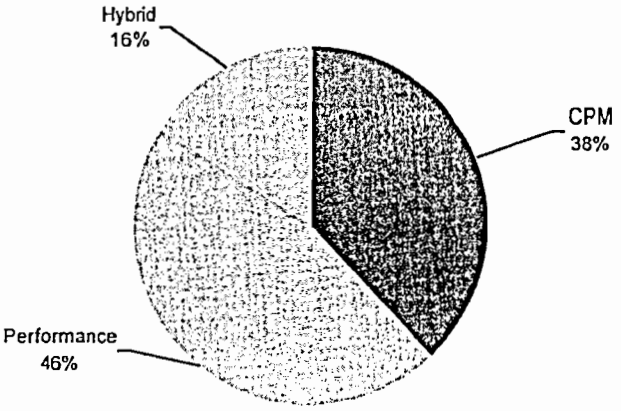
Internet Ad Revenues by Pricing Model

% of 2005 Fourth-Quarter Revenues



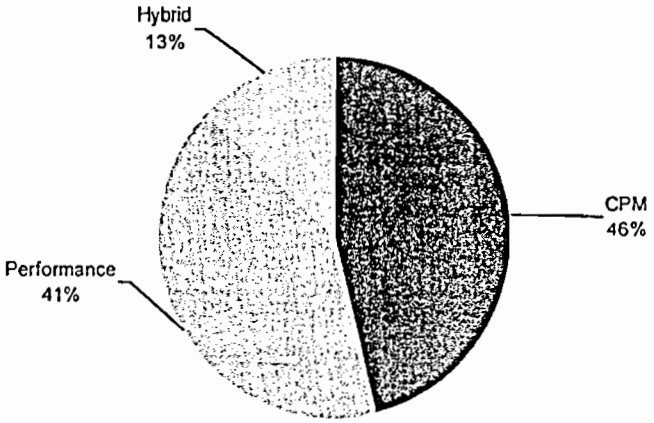
Total – $3.6 Billion

% of 2004 Fourth-Quarter Revenues



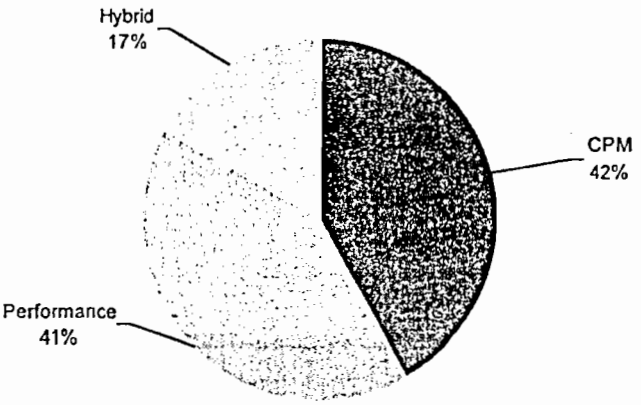
Total – $2.7 Billion

% of 2005 Full-Year Revenues



Total – $12.5 Billion

% of 2004 Full-Year Revenues

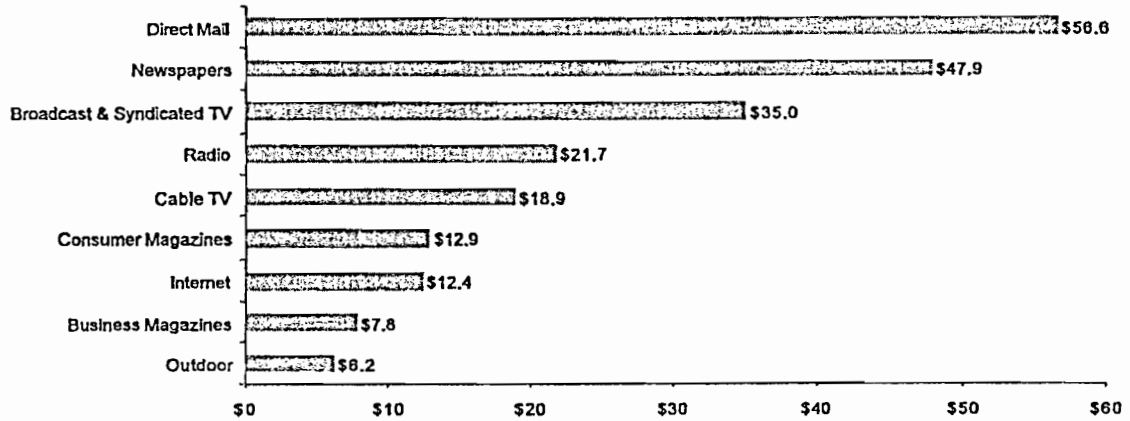


Total – $9.6 Billion

U.S Advertising Marketshare

- Internet advertising revenues accounted for approximately 4.7 percent of total U.S. ad spending* in 2005, up from approximately 3.7 percent in 2004.

U.S. Advertising Market-Media Comparisons – 2005 ($ Billions)



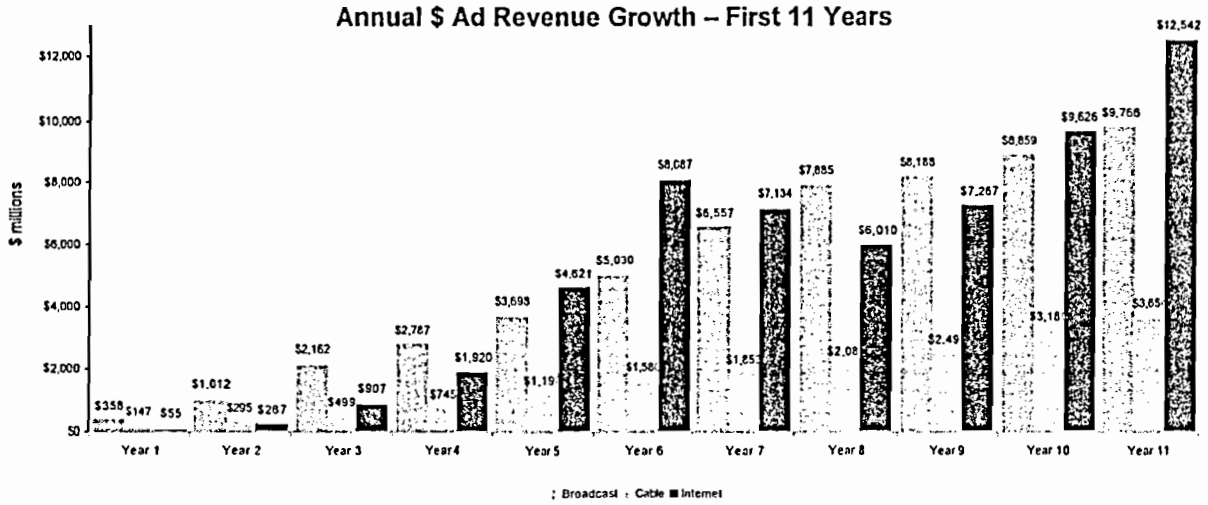
*The total U.S. advertising market is estimated at approximately $267 billion, and includes other segments not charted here.

Sources: IAB Internet Ad Revenue Report; PricewaterhouseCoopers LLP; Universal McCann

Initial Year Growth Comparisons – Internet Advertising vs. Broadcast and Cable Television

- The first 11 years of Internet Advertising (1995-2005) were charted against broadcast television (1949-1958) and cable television (1980-1989), presented in current dollars.
- Internet advertising revenues surpassed cable television revenues in its third year of growth, and broadcast television revenues in its fifth year of growth. Internet advertising revenues measured below broadcast television in years eight and nine, and surpassed it again in years ten and eleven.

Annual $ Ad Revenue Growth – First 11 Years



Sources: IAB Internet Ad Revenue Report, PricewaterhouseCoopers LLP; Universal McCann

Appendix

Definitions of Leading Industry Categories*

The industry categories used in the IAB Internet Advertising Revenue Report were sourced from the Northern American Standard Industrial Classification (SIC) Manual.*

Consumer Related – includes industry categories classified as consumer-related, including automotive, mail order/catalog, travel/hotel/airlines, amusement & recreation, apparel, drug stores, home furnishings/textiles, retail stores, cosmetics, jewelry, restaurants/fast food, household products, tobacco, toys, pet food/supplies and appliances.

Computing Products – includes hardware (computers, computer storage devices, and computer peripheral equipment), prepackaged software (operating, utility and applications programs), local area network systems and network systems integration, computer processing and data preparation, and data processing services.

Financial Services – includes commercial banks, credit agencies, personal credit institutions, consumer finance companies, loan companies, business credit institutions, and credit card agencies. Also includes companies engaged in the underwriting, purchase, sale or brokerage of securities and other financial contracts.

Telecommunications – includes point-to-point communications services, including telephone voice and data communications, two-way mobile/cellular communications services, and other non-vocal message communications services (e.g., cablegram, electronic mail and facsimile).

Media – includes establishments primarily engaged in radio and television broadcasting (network and station) including commercial, religious, educational, and other radio or television stations. Includes multi-channel video providers on a subscription fee basis (e.g., cable television, wireless cable television, and direct broadcast satellite services). Also includes establishments primarily engaged in publishing newspapers, periodicals and books.

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* *Survey participants reported results based on the separate industry categories listed on page 14, which were used specifically for the IAB Internet Advertising Revenue Report. This is consistent with other relevant industry categorization sources that measure advertising spending by industry. For purposes of this report, PricewaterhouseCoopers classified a number of individual categories under "Consumer Related."*

Definitions of Advertising Formats

Display Advertising – advertiser pays an on-line company for space to display a static or hyper-linked banner or logo on one or more of the on-line company's pages.

Sponsorship – advertiser sponsors targeted Web site or email areas (e.g., entire web site, site area, an event, parts or all of an email message). Sponsorships can and usually do contain some banner elements. To the extent possible, separate and report revenues for other formats contained within the sponsorship campaign.

E-mail – banner ads, links or advertiser sponsorships that appear in e-mail newsletters, e-mail marketing campaigns and other commercial e-mail communications. Includes all types of electronic mail (e.g., basic text or HTML-enabled).

Search – fees advertisers pay on-line companies to list and/or link their company site domain name to a specific search word or phrase (includes paid search revenues). Search categories include:

- *Paid listings* – text links appear at the top or side of search results for specific keywords. The more a marketer pays, the higher the position it gets. Marketers only pay when a user clicks on the text link.
- *Contextual search* – text links appear in an article based on the context of the content, instead of a user-submitted keyword. Payment only occurs when the link is clicked.
- *Paid inclusion* – guarantees that a marketer's URL is indexed by a search engine. The listing is determined by the engine's search algorithms.
- *Site optimization* – modifies a site to make it easier for search engines to automatically index the site and hopefully result in better placement in results.

Lead Generation/Referrals* – fees advertisers pay to online companies that refer qualified purchase inquiries (e.g., auto dealers which pay a fee in exchange for receiving a qualified purchase inquiry online) or provide consumer information (demographic, contact, behavioral) where the consumer opts into being contacted by a marketer (email, postal, telephone, fax). These processes are priced on a performance basis (e.g., cost-per-action, -lead or -inquiry), and can include user applications (e.g., for a credit card), surveys, contests (e.g., sweepstakes) or registrations.

Classifieds and auctions – fees advertisers pay on-line companies to list specific products or services (e.g., on-line job boards and employment listings, real estate listings, automotive listings, auction-based listings, yellow pages).

Rich media – advertisements that integrate some component of streaming video and/or audio and interactivity, in addition to flash or java script ads, and can allow users to view and interact with products or services (e.g., a multimedia product description, a "virtual test-drive"). "Interstitials" have been consolidated within the rich media category and represent full- or partial-page text and image server-push advertisements which appear in the transition between two pages of content. Forms of interstitials can include splash screens, pop-up windows and superstitials.

Slotting fees – fees charged to advertisers by on-line companies to secure premium positioning of an advertisement on their site, category exclusivity or similar preference positioning (similar to slotting allowances charged by retailers).

**Definition expanded in 2005 to better reflect lead generation activity.*

Survey Scope

The Interactive Advertising Bureau (IAB) retained PricewaterhouseCoopers to establish a comprehensive standard for measuring the growth of Internet/on-line advertising revenues.

- The IAB Internet Advertising Revenue Report is an ongoing IAB mission to provide an accurate barometer of Internet advertising growth.
- To achieve differentiation from existing estimates and accomplish industry-wide acceptance, key aspects of the survey include:
  - Obtaining historical data directly from companies generating Internet/on-line advertising revenues;
  - Making the survey as inclusive as possible, encompassing all forms of Internet/on-line advertising, including Web sites, consumer on-line services and e-mail providers; and
  - Ensuring and maintaining a confidential process, only releasing aggregate data.

Methodology

- PricewaterhouseCoopers:
  - Compiles a database of industry participants selling Internet/on-line advertising revenues.
  - Conducts a quantitative mailing survey with leading industry players, including Web publishers, commercial on-line service providers, e-mail providers and other on-line media companies.
  - Requests and compiles several specific data items, including monthly gross commissionable advertising revenue by industry category and transaction.
  - Identifies non-participating companies and applies a conservative revenue estimate based on available public sources.
  - Analyzes the findings, identifies and reports key trends.
  - The 2001 and 2000 full-year revenue data were adjusted to reflect revenue restatements reported in public filings by several individual companies. Those reported restatements totaled $77 million in 2001 and $138 million in 2000. Historical industry revenue figures are now adjusted to $7.134 billion in 2001 and $8.087 billion in 2000.

Survey Industry Categories

Entertainment (Film, TV, Music)

Apparel

Household Products

Automotive

Consumer Packaged Goods

Computers & Peripherals

Retail

Educational Services

Pet Food/Supplies

Restaurants/ Fast food

Financial Services (Banks, Insurance, Securities, Real Estate)

Business Equipment/ Supplies

Pharmaceuticals

Media (Broadcast, Cable, Publishing)

Telecommunications

Health Care Services

Professional Sports

Toiletries & Cosmetics

Leisure (Travel, Hotels, Resorts)

Business Services

Manufacturing

Overall Report Guidance Provided by IAB Leadership

Executive Committee

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Dave Yovanno
ValueClick Media

About the Interactive Advertising Bureau

Founded in 1996, the Interactive Advertising Bureau (www.iab.net) represents over 250 leading interactive companies that actively engage in, and support the sale of interactive advertising. IAB members are responsible for selling over 86% of online advertising in the United States. On behalf of its members, the IAB evaluates and recommends standards and practices; fields interactive effectiveness research, and educates the advertising industry about interactive advertising.

PricewaterhouseCoopers New Media Group

PricewaterhouseCoopers LLP (www.pwc.com) provides industry-focused assurance, tax and advisory services for public and private clients. More than 120,000 people in 139 countries connect their thinking, experience and solutions to build public trust and enhance value for clients and their stakeholders.

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PricewaterhouseCoopers' New Media Group was the first practice of its kind at a Big Four firm. Currently located in New York, Los Angeles, Boston, Seattle and the Bay Area, our New Media Group includes accounting, tax and consulting professionals who have broad and deep experience in the three areas that converge to form new media: advanced telecommunications, enabling software and content development/distribution.

Our services to the new media industry include:

- Business assurance services
- Web audience measurement auditing and advisory
- Web advertising delivery auditing and advisory
- Privacy policy structuring, attestation and compliance advisory
- Mergers & Acquisition assistance
- Tax planning and compliance
- Capital sourcing and IPO assistance

PricewaterhouseCoopers LLP is a licensed CPA WebTrust auditor, a designated TRUSTe auditor, and the leading service provider in the area of Web Advertising Delivery Auditing.

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EXHIBIT CO 0728

PEW/INTERNET

PEW INTERNET & AMERICAN LIFE PROJECT

DATA MEMO

BY: **Research Specialist Mary Madden (202-419-4500)**

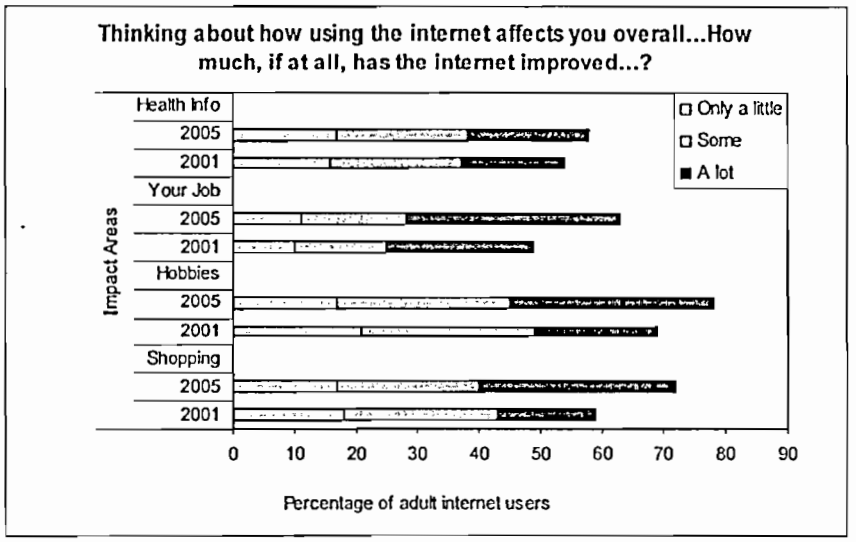
RE: **Internet penetration and impact**
April 2006

Internet penetration has now reached 73% for all American adults. Internet users note big improvements in their ability to shop and the way they pursue hobbies and personal interests online

The importance of the internet in key areas is growing

As one measure of the impact of the internet, we have repeatedly asked online Americans whether or not the internet has improved various aspects of their life. Over time, internet users have become more likely to note big improvements in their ability to shop and the way they pursue their hobbies and interests. A majority of internet users also consistently report that the internet helps them to do their job and improves the way the get information about health care. Some key findings are listed below:

- The share of online Americans who say the internet has greatly improved their **ability to shop** has doubled—from 16% to 32%—since March 2001.
- The share of online Americans who say the internet has greatly improved the way **they pursue hobbies and interests** has grown to 33%, up from 20% in March 2001.
- The share of online Americans who say the internet has greatly improved their **ability to do their job** has grown to 35%, up from 24% in March 2001.
- The share of online Americans who say the internet has greatly improved the way **they get information about health care** has grown to 20%, up from 17% in March 2001.



Source: For 2005 data, Pew Internet & American Life Project November-December 2005 Tracking Survey, n=1,931 adult internet users, 18 and older. Margin of error is plus or minus 2 percentage points for results based on internet users. For 2001 data, Pew Internet & American Life Project March 2001 Longitudinal Callback Survey, n=862 adult internet users, 18 and older. Margin of error is plus or minus 4 percentage points for results based on internet users.

Those who use the internet most cite the biggest improvements

In all four categories (health information, job, hobbies and shopping), the internet earns the highest marks among the most frequent users. For instance, daily internet users are twice as likely to report that the internet improves their ability to do their job "a lot" when compared with those who only go online several times a week (45% vs. 17%). Likewise, 39% of daily internet users report that the internet has improved the way they pursue their hobbies and interests "a lot," while about half as many (21%) users who go online several times per week say this.

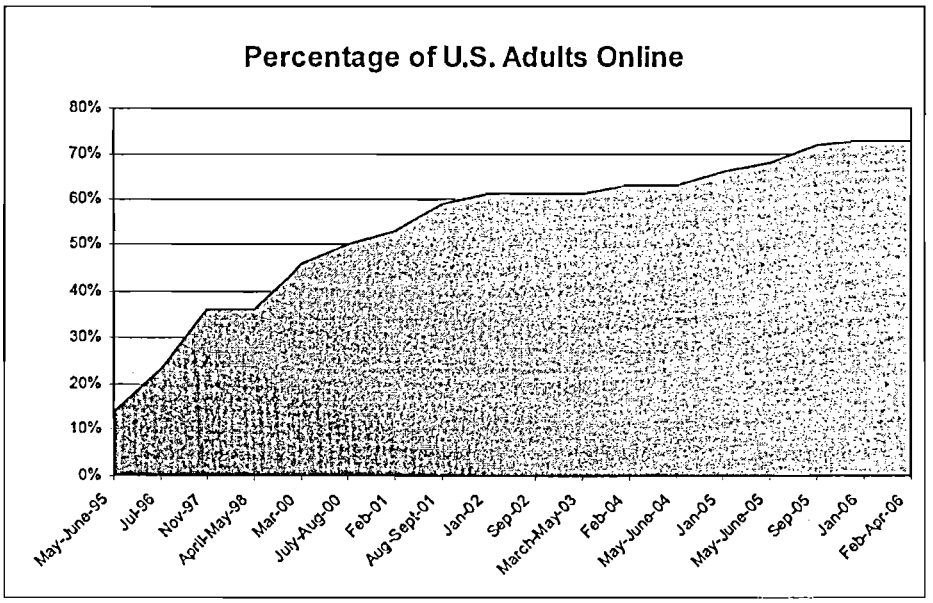
Equal shares of men and women note the positive effects of the internet in commerce and the workplace; about a third of both groups say the internet has improved their ability to shop or do their job "a lot." Improved access to healthcare information is more likely to be noted by women (22% of female users say the internet has improved the way they get health care information "a lot" vs. 17% of male users), while greater numbers of men tout their improved ability to pursue hobbies and interests (38% of male users say the internet has improved the way they pursue their hobbies and interests "a lot" vs. 27% of female users).

For shopping, younger users are more likely to report big improvements overall, but older users report more growth over time. However, with hobbies, users under the age of 50 report *both* the most positive effects and the biggest increases since 2001. Those who note the way the internet helps them to do their job report relatively little variation according to age. Only those who are age 65 and older (and likely to be retired) are dramatically less likely to praise the internet's role in their job. Health care also generally

yields comparable positive marks across the generations, with the most change since 2001 registering among the youngest (18-29) and oldest (65+) users.

Internet penetration reaches a new high-water mark

While the share of internet users who report positive impacts has grown, the sheer size of the internet population also continues to increase. Surveys fielded in 2006 show that internet penetration among adults in the U.S. has hit an all-time high.[1] While the percentage of Americans who say they use the internet has continued to fluctuate slightly, our latest survey, fielded February 15 – April 6, 2006 shows that fully 73% of respondents (about 147 million adults) are internet users, up from 66% (about 133 million adults) in our January 2005 survey. And the share of Americans who have broadband connections at home has now reached 42% (about 84 million), up from 29% (about 59 million) in January 2005.



Source: Pew Internet & American Life Project Surveys, March 2000-April 2006. All surveys prior to March 2000 were conducted by the Pew Research Center for People & the Press.[2]

[1] Two surveys in 2006 (one fielded January 9 – February 6, 2006, and the most recent survey fielded February 15 – April 6, 2006) show that 73% of adults use the internet.

[2] For 1995, internet users include those who ever use a home, work or school computer and modem to connect to computer bulletin boards, information services such as CompuServe or Prodigy, or computers at other locations. For 1996 to 1998, internet users include those who ever use a home, work or school computer and modem to connect with computers over the internet, the World Wide Web, or with information services such as America Online or Prodigy. For 2000 to 2004, internet users include persons who ever go online to access the Internet or World Wide Web or to send and receive email. For 2005, internet users include those who at least occasionally use the internet or send and receive email.

As noted recently in our *Generations Online* report, internet use still varies significantly across age groups. While 88% of 18-29 year-olds now go online, 84% of 30-49 year-olds, 71% of 50-64 year-olds, and 32% of those age 65 and older say they use the internet. In a separate survey conducted in Oct-Nov 2004, we found that 87% of 12-17 year-olds use the internet.

Those in the lowest-income households are considerably less likely to be online. Just 53% of adults living in households with less than $30,000 in annual income go online, versus 80% of those whose income is between $30,000-50,000. Adults who live in households earning $50,000 or more exceed the national average for internet penetration; 86% of adults living in households with annual income between $50,000 and $75,000 use the internet, compared with 91% of adults living in households earning more than $75,000.

Education also remains an important indicator for internet use. While 40% of adults who have less than a high school education use the internet, 64% of adults with a high school degree go online. Among those who have some college education, 84% use the internet, and 91% of adults with at least a college degree go online.

About The Pew Internet & American Life Project

The Pew Internet & American Life Project is a non-profit initiative, fully-funded by The Pew Charitable Trusts to explore the impact of the internet on children, families, communities, health care, schools, the work place, and civic/political life. The Project is non-partisan and does not advocate for any policy outcomes. For more information, please visit our website: http://www.pewinternet.org/.

Methodology

The newly reported results in this report are based on data from a series of telephone interviews conducted by Princeton Survey Research Associates International between November 2005 and April 2006. For results based on the full sample of 3,011 adults, 18 and older, conducted November 29 - December 31, 2005, one can say with 95% confidence that the error attributable to sampling and other random effects is plus or minus 2 percentage points. For results based on internet users (n=1,931), the margin of error is plus or minus 2 percentage points. For results based on the full sample of 4,001 adults, 18 and older, conducted February 15 - April 6, 2006, one can say with 95% confidence that the error attributable to sampling and other random effects is plus or minus 2 percentage points. For results based adult internet users (n=2,822), the margin of sampling error is plus or minus 2 percentage points. In addition to sampling error, question wording and practical difficulties in conducting telephone surveys may introduce some error or bias into the findings of opinion polls.

The sample for the most recent survey (February 15 - April 6, 2006) is a random digit sample of telephone numbers selected from telephone exchanges in the continental United States. The random digit aspect of the sample is used to avoid "listing" bias and provides representation of both listed and unlisted numbers (including not-yet-listed

numbers). The design of the sample achieves this representation by random generation of the last two digits of telephone numbers selected on the basis of their area code, telephone exchange, and bank number.

Sample was released for interviewing in replicates, which are representative subsamples of the larger sample. Using replicates to control the release of sample ensures that complete call procedures are followed for the entire sample. At least 10 attempts were made to complete an interview at sampled households. Calls were staggered over times of day and days of the week to maximize the chance of making contact with potential respondents. Each household received at least one daytime call in an attempt to find someone at home. In each contacted household, interviewers asked to speak with the youngest male currently at home. If no male was available, interviewers asked to speak with the oldest female at home. This systematic respondent selection technique has been shown to produce samples that closely mirror the population in terms of age and gender.

Non-response in telephone interviews produces some known biases in survey-derived estimates because participation tends to vary for different subgroups of the population, and these subgroups are likely to vary also on questions of substantive interest. In order to compensate for these known biases, the sample data are weighted in analysis. The demographic weighting parameters for the most recent sample (February 15 - April 6, 2006) are derived from a special analysis of the Census Bureau's March 2005 Annual Social and Economic Supplement Survey. This analysis produces population parameters for the demographic characteristics of adults age 18 or older, living in households that contain a telephone. These parameters are then compared with the sample characteristics to construct sample weights. The weights are derived using an iterative technique that simultaneously balances the distribution of all weighting parameters.

For more information about the March 2001 Longitudinal Callback Survey, please see: http://207.21.232.103/PPF/r/55/report_display.asp

For more information about the latest trends in internet use, please see: http://www.pewinternet.org

EXHIBIT CO 0729

Annual Report 2005

EMI

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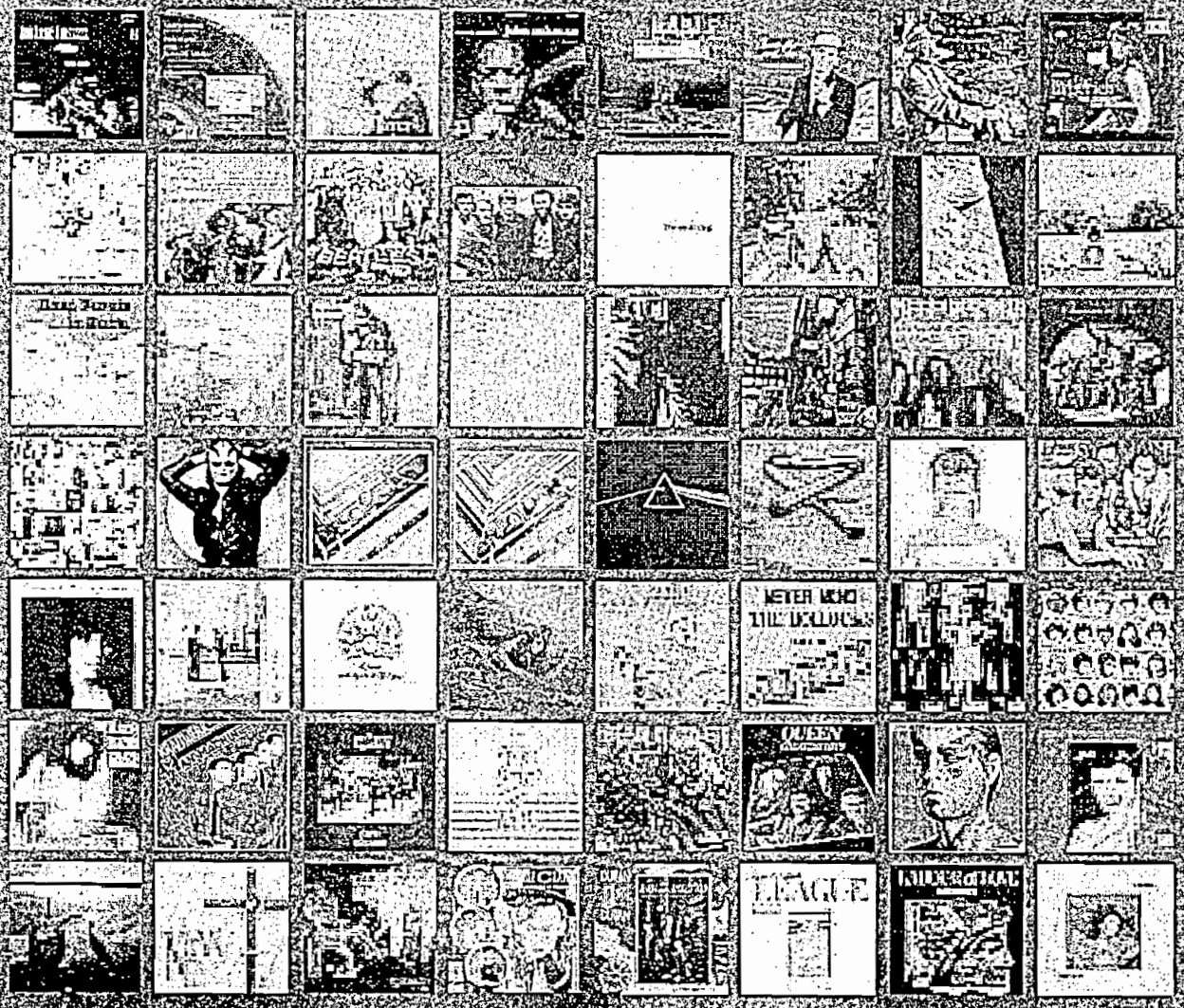
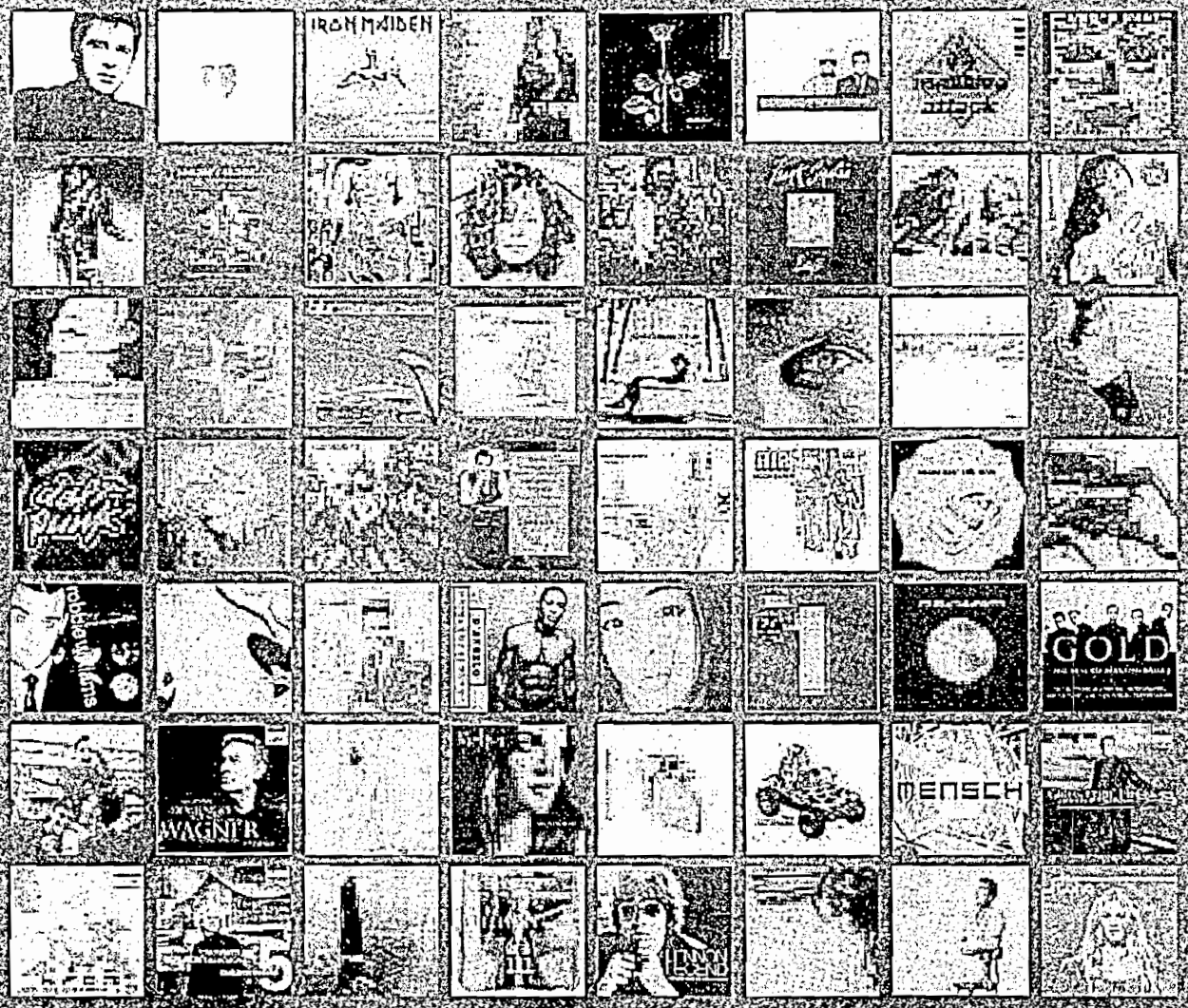
Our company
More than 230 online stores around the world now offer music legally, over 10 times the number in January 2003.
Source: IFPI
Click

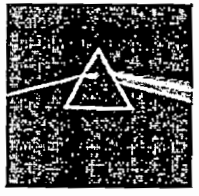
The world's finest record collection



EMI Music owns an outstanding catalogue of recordings covering all key music genres.
This is a selection of just some of the best-selling albums in the EMI catalogue.



Our company



EMI is a music content company operating in more than 50 countries. Our music publishing company is the largest and most successful in the world. We have many renowned labels, including Blue Note, Capitol, Capitol Nashville, EMI Christian Music Group, EMI Classics, Parlophone and Virgin as well as the legendary Abbey Road Studios.

Our aim is to build shareholder value by developing the best musical content at EMI Music and EMI Music Publishing and fully exploiting this unique content on a global basis through all viable and economically attractive channels. We do this by working with, and nurturing, the world's best recording artists and songwriters; marketing and promoting their music; and delivering it to consumers in the ways they want.

Now is a very good time to be the owner of exceptional creative content. The digital revolution has dramatically changed how consumers can access and buy music and is expanding retail opportunities. New formats, uses, outlets and channels for our music content – particularly those related to digital music – are providing real growth in our markets. We continue to invest in a considered, structured way to yield the greatest value from our music content and the many new opportunities brought about by digital advances.

Creative industries such as music have long been recognised for their social, cultural and educational contribution. Today, they lie at the heart of the modern information society and are increasingly seen by governments and policymakers as key drivers of economic prosperity and innovation.

EMI today has an outstanding catalogue of songs and recordings covering all key music genres, geographies and time periods. We constantly strive to expand this catalogue, as hits of today become the classics of tomorrow.

EMI Music has a diverse roster of around 1,000 talented recording artists, including music legends such as The Beatles, the Rolling Stones and Mstislav Rostropovich; contemporary big sellers like Norah Jones, Robbie Williams, Kylie Minogue and Coldplay; newly successful acts such as Joss Stone, Keith Urban and Yellowcard; plus some of the finest classical artists including Nigel Kennedy, Simon Rattle, Itzhak Perlman and Angela Gheorgiu.

EMI Music Publishing's one million strong song catalogue contains older and contemporary titles – the product of many of the world's leading songwriters. Our perennial best-selling songs include *Bohemian Rhapsody*, *I Heard It Through The Grapevine*, *New York, New York*, *Over the Rainbow*, the *James Bond theme*, *Singin' In The Rain*, *Santa Claus is Comin' to Town*, *Wild Thing*, *We Will Rock You*, *Angels*, *Baby Love*, *Crazy In Love* and *Daydream Believer*.

The music industry has always been highly competitive and technological advances, in recent years, have led to considerable change. EMI has embraced this change, taking important steps to position our company so that we compete most effectively, and can grow and benefit as our market improves. We have built a highly capable, experienced management team, strengthened our capital structure, improved our business disciplines, developed new business models and, most importantly, continued to invest in the best creative talent around the world.

‘Our aim is to build shareholder value by developing the best musical content and fully exploiting this unique content on a global basis.’

TRADE MARK
Parlophone

Improving operations
Central to EMI's strategy is our commitment to continuous improvement in our effectiveness as well as our efficiency. We have taken a series of steps to lower our fixed costs and improve our profitability. Over the last three years these efforts have reduced our fixed costs by £150m. We have already delivered £135m of those savings, and expect to realise the remaining £15m in the financial year just started.

Among the initiatives taken, we have reorganised our North American recorded music operations, consolidated back office functions and streamlined certain labels in Continental Europe. In addition, we have outsourced our primary manufacturing facilities which will maximise our flexibility in a music world that we believe will become less oriented toward physical products.

We are currently investing in a technology change programme in both businesses that will enable us to harness the opportunities brought about by digital technology. This multi-year effort is well underway, developing the infrastructure upon which we can grow and compete yet more effectively, further enhance our profitability and ensure that our artists reach their highest potential.

Of course, as important as an effective strategy is a company's capability to execute that strategy. Our people are the lifeblood of our company and we are committed to their personal development. We employ talented individuals with creativity, a passion for music, a willingness to take risks and a spirit of enterprise – all balanced by financial responsibility, integrity and accountability.

Developing and marketing our music content
We have continued to invest in our recording artists and songwriters, building our bank of content. While music by the likes of The Beatles, Pink Floyd, Queen, Maria Callas, Frank Sinatra, Nat King Cole and The Beach Boys can be timeless and generate attractive revenue for decades, current artists and songwriters whose music forms an important part of today's popular culture are essential for delivering sustained growth. An area of particular focus is the expansion of our American repertoire. This offers good growth prospects for EMI Music as we are still relatively underrepresented in the US recorded music market.

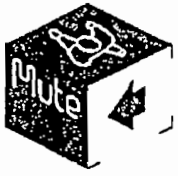
EMI Music and EMI Music Publishing are committed to developing a portfolio that spans key musical styles or genres to serve the shifting tastes of consumers. Both also maintain a global approach to building their rosters, focusing on artists and songwriters with international appeal as well as those whose music is targeted at a national audience. Locally originated music is an important element in a range of countries. For example, in Japan about 70% of music sold is from local artists, 60% in France and about 50% in Italy and Spain. We believe that to be the most successful music company, we must compete effectively with both international and local music.

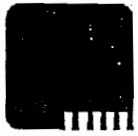
The world's greatest songs

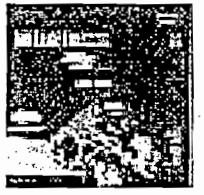
ABC Ain't No Mountain High Enough Always On My Mind At Last Baby I Need Your Loving Bent Blue Moon Bohemian Rhapsody The Boy Is Mine Breaking Up Is Hard To Do Can't Get You Out Of My Head Can't Take My Eyes Off You Chattanooga Choo Choo Crazy In Love Da Ya Think I'm Sexy Dancing In The Street Drops Of Jupiter Everlasting Love Every Breath You Take Fallin' Fast Car Frontin' Genie In A Bottle Get Busy Gonna Fly Now The Good, The Bad And The Ugly (Theme) A Groovy Kind Of Love Help Me Make It Through The Night Here And Now Hero How Sweet It Is (To Be Loved By You) I Heard It Through The Grapevine I Left My Heart In San Francisco I Second That Emotion I'll Be Missing You I'm A Believer Imagine Iris It Don't Mean A Thing (If It Ain't Got That Swing) It's Only Rock n' Roll (But I Like It) The James Bond Theme Just Like A Pill Lady Marmalade Let's Get It On Let's Hang On (To What We've Got) Let The Sunshine In The Loco-motion Louie Louie Maggie May Material Girl Me And Bobby McGee Money (That's What I Want)

EMI Music Publishing controls the copyright to more than 1 million hit songs. Together they comprise the best-performing song catalogue in the world.

Mony Mony Moonlight Serenade My Girl Never Can Say Goodbye No More Drama Nobody Does It Better Oh Happy Day On Bended Knee On Broadway One More Night Orinoco Flow (Sail Away) Oye Como Va Over The Rainbow The Pink Panther Theme Put A Little Love In Your Heart Reach Out I'll Be There Santa Claus Is Comin' To Town The Shadow Of Your Smile Singin' In The Rain Smells Like Teen Spirit Someday We'll Be Together Stand By Your Man Stardust Start Me Up Stop! In The Name Of Love Stranger On The Shore Superman (It's Not Easy) That's The Way (I Like It) Theme From 'New York, New York' Three Times A Lady Touch Me In The Morning Try A Little Tenderness Tubular Bells U Got It Bad Walk On The Wild Side The Way We Were War The Way You Do The Things You Do We Will Rock You What Becomes Of The Brokenhearted What's Going On Where Were You (When The World Stopped Turning) Wild Thing Will You Love Me Tomorrow You Are The Sunshine Of My Life You Can't Hurry Love You've Got a Friend







EMI Music Publishing signs songwriters who are capable of writing the hits of today. These songs will sell year after year as EMI markets them so they are repeatedly performed, recorded or used in advertisements, films, television programmes or computer games. Many of these songwriters are current recording artists with an established, active market for their music. However, EMI has also sought out talented writer/producers who work with the top recording artists. Through this approach, EMI Music Publishing has maintained the world's leading roster of active songwriters whose collective presence in the current charts towers above other publishers. Our prolific songwriters include Alicia Keys, Usher, Jamiroquai, Kanye West, Ms Dynamite, Rob Thomas, Norah Jones, Jay-Z, Cathy Dennis, Guy Chambers, Pharrell Williams, Scissor Sisters, P. Diddy and Sting.

EMI Music focuses on signing and developing recording artists with the potential for growing success over a series of albums. Through targeted marketing and promotion of that music we seek to build an ever-broadening set of fans for each artist. We believe that developing long-term career artists, who have a substantial base of fans eagerly awaiting each new release, is the best way to grow sales and optimise profitability. The following are a few examples from our active roster of career artists:

- Robbie Williams has released a total of eight albums and a range of DVD-music videos with EMI. Collectively, these have sold over 40m units since 1997 – and they keep selling. Robbie Williams is recording his next album which is planned for release in the current financial year.
- At the beginning of 2002, Norah Jones was a virtually unknown artist. Since then, she has become a global superstar, selling almost 30m units of her two albums. With this level of sales, along with her record-setting eight Grammy awards won in one year, Norah Jones is one of the top female artists in the world today.
- We have released four albums by Utada Hikaru since 1999 and she is now one of the most popular Japanese artists recording today. Her albums and videos have collectively sold over 25m units.
- Coldplay has developed a massive global fan base through its two albums. The first album has sold 7m units while their second has sold 10m copies so far. Their eagerly awaited third album, *X & Y*, is being released in June 2005.
- Joss Stone, Chingy and Keith Urban are all examples of new artists from our US labels who EMI has broken through to multi-million unit sales success in the last two years, and who also during that time have each had two albums selling in excess of 1m units.

Exploiting our creative content

As the owner of one of the world's best catalogues of music content, EMI has been, and continues to be, intensely focused on maximising the uses, formats and outlets for our recording and song copyrights.

The music industry is undergoing a transformation brought about by new digital music formats and channels. While digital technologies enable new, virulent forms of music piracy, they can also offer new legal ways to consume music and are ultimately fuelling consumers' appetite for music. The explosion in digital music catalysed by portable players such as the iconic iPod and mobile phones are helping to transform the consumer experience and creating exciting, new revenue opportunities. So while driving our own business in new directions, we are stimulating other new businesses which will create growth for us all in the future.

In this digital environment, protecting the use and term of our music copyrights is an ever more important element of our strategy. Over the last three years, we have increased our investment in fighting piracy, both online and physical. We have established a team around the world who develop and implement anti-piracy initiatives locally. We are at the forefront of the industry's efforts in this area, raising the level of consumer awareness, lobbying governments, utilising technological countermeasures, and, where necessary, taking legal actions against those stealing or facilitating the theft of music. We believe these efforts are having a positive impact.

Consumer acceptance of digital music since launch has been exceptionally strong. It is estimated that the global recorded music industry has seen digital music go from virtually nothing two years ago to more than 2% of sales in the financial year just ended, and an estimated 3% to 4% of sales in the first calendar quarter of 2005. We recognise that it is very difficult today to forecast the multi-year path of digital industry sales, as these are still early days for digital music.

Consumer-based econometric research commissioned by EMI projects that digital music, in all its forms, could represent as much as 25% of total global recorded music industry sales in five years. While a portion of digital sales will substitute for physical sales, the research finds that the overall effect of digital music is positive for the industry, and could drive a compound annual growth rate of 5% to 2010 for the global recorded music market. Other research companies have estimated similar levels of total music industry growth, given their projected positive impact from digital music.

This type of digital uptake will be beneficial to both arms of our business, fuelling revenue growth and profitability increases. While physical formats will likely be the larger part of our business for many years to come – and there remains a host of opportunities to develop new physical propositions – digital music expands consumers' opportunities to buy music. Stores are open round the clock and product is never out of stock. Shelf space is unlimited, enabling us to offer the full range of our catalogue including the older hits, specialised genres and music in all languages.

Certain costs borne in the physical world such as manufacturing, returns and pick-pack-ship are not relevant for digital products. For physical products, these costs are in the range of 15% to 18% of sales. While there are some digital-specific variable costs and infrastructure investments needed to fully pursue the digital opportunity, it is reasonable to expect that our company will be more profitable as digital sales grow as a proportion of our business.

Developing technologies and business models centred around digital music are presenting new and exciting opportunities on an almost daily basis for our music content. While we cannot yet be precise on the magnitude and timing of this growth, we are pursuing it with our full energy, confident in the strength of our position as the owner of a highly valuable commodity – one of the best banks of music content in the world.

Eric Nicoli
Chairman

EMI annual report for the year ended 31 March 2005

- Sales in constant currency grew by 4.9% at EMI Music Publishing but fell by 7.4% at EMI Music, resulting in a 5.1% decline in turnover for EMI Group
- Group digital sales more than tripled to £49.7m, delivering 2.5% of total turnover for the year and 3.5% in the final quarter
- Group operating margin increased to 12.0% from 11.8%
- Restructuring initiatives delivered cost savings of £35m in the year, £10m ahead of plan
- Group profit before tax, amortisation and exceptional items was £141.9m, in line with EMI's 15 April trading update
- Full-year dividend maintained at 8.0p per share

Financial summary

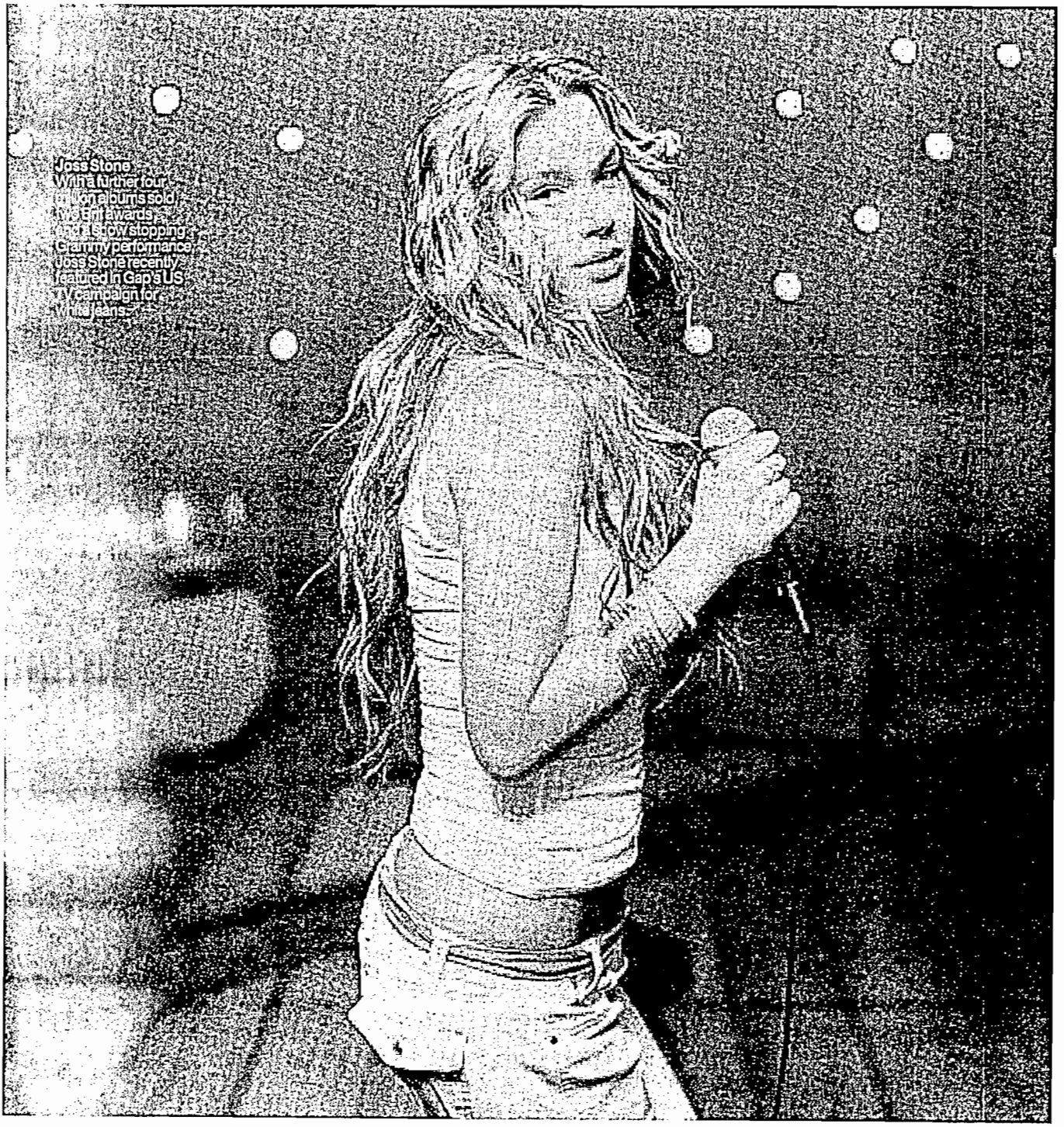
	Year ended 31 March 2005 £m	Year ended 31 March 2004 £m
Group turnover	1,942.8	2,120.7
EBITDA (i)	256.8	284.3
Group operating profit (EBITA) (ii)	232.9	249.3
Adjusted PBT (iii)	141.9	163.3
Profit (loss) before taxation	91.8	(52.8)
Adjusted diluted earnings per share (iv)	13.0p	15.5p
Basic earnings per share	7.2p	(9.1)p
Dividend per share	8.0p	8.0p
Return on sales (v)	12.0%	11.8%
Interest cover (vi)	3.0x	3.3x

(i) EBITDA is Group operating profit before operating exceptional items, depreciation and amortisation of goodwill and music copyrights.
(ii) Group operating profit (EBITA) is before operating exceptional items and amortisation of goodwill and music copyrights.
(iii) Adjusted PBT is before operating, non-operating and financial exceptional items and amortisation of goodwill and music copyrights.
(iv) Adjusted diluted earnings per share is before operating, non-operating and financial exceptional items and amortisation of goodwill and music copyrights.
(v) Return on sales is defined as Group operating profit before operating exceptional items and amortisation of goodwill and music copyrights as a percentage of Group turnover.
(vi) Interest cover is defined as the number of times EBITDA is greater than Group finance charges, excluding non-periodic interest and exceptional items.

Discover.

It is estimated there will be 2 billion mobile phone subscriptions worldwide by the end of 2005.

Source: Nokia



Joss Stone
With a further four million albums sold, two Brit awards, and a show stopping Grammy performance, Joss Stone recently featured in Gap's US TV campaign for Wind jeans.

Chairman's statement

Eric Nicoli
Chairman
EMI Group

Global music market conditions continued to improve during the year. A key driver has been the very rapid growth in legitimate digital music. For the year, digital music represented more than two percent of the global music market as compared to last year when sales had just started to take off. We remain confident that digital music will drive the industry forward at attractive growth rates in the coming years and that it will become a significantly larger proportion of our business.

We are also encouraged by trends in global physical music sales, where declines continued to moderate. During the year we saw a considerable improvement in Continental Europe, one of the most challenging regions in recent years. While we still saw a decline in value year-on-year, the magnitude of decline has significantly reduced, particularly in the key German and French markets. We also saw a notable improvement in the Japanese and Latin American markets. The North American market softened during the year, particularly during our second half.

EMI Music's performance for the financial year was impacted by lower than anticipated reorders in the fourth quarter and the rescheduling of two major albums into the current financial year. We believe that the fundamental business under the leadership of Alain Levy has made, and will continue to make, good progress.

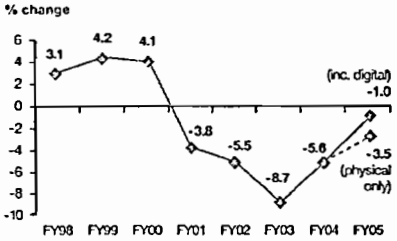
During the year, we successfully completed our announced restructuring initiatives at EMI Music, including the outsourcing of manufacturing in the United States and Europe and the restructuring of some of our labels in particular in Continental Europe. These initiatives delivered combined cost savings of £35m in the year, £10m ahead of plan. The remaining £15m of annualised savings are expected to be realised in the current financial year, bringing the total annualised cost savings to £50m. We continue to be focused on improving our overall efficiency through efforts targeted at procurement and marketing effectiveness together with our IT change programme.

EMI Music has continued to invest in artist development, the core of our business, and has a strong track record of developing artists who have success on a multiple-album basis. Top sellers in the year included albums from Robbie Williams, Tina Turner, Norah Jones, Beastie Boys, Blue, Kylie Minogue, Lenny Kravitz, Chingy and Moby. During the year, EMI Music continued to build upon the initial success of newer superstars, Joss Stone, Keith Urban and Yellowcard. We are continually strengthening our active roster of global superstars which numbers nearly 50 artists.

EMI Music is aggressively pursuing the digital market. During the year, we have worked hard to put in place the right digital partnerships globally to ensure that, as an owner of digital content, we maximise this opportunity.

EMI Music Publishing has further strengthened its position as the leading global music publisher. Martin Bandier and his team continued to sign today's very best song-writing talent during the last financial year, including Eminem and Scissor Sisters, and we continue to lead the industry in our ability to maximise revenues from the songs in EMI's exceptional catalogue.

Global music market
(%)



Source: EMI and IFPI

During the year, EMI Music Publishing has been at the forefront of the digital market development including, in December 2004, the ground-breaking agreement between EMI Music Publishing and Sony BMG on new digital products for the US and Canadian markets. We are committed to capturing the full benefits of digital and, looking ahead, we expect both the digital opportunity and improved conditions in the recorded music market to drive attractive growth.

EMI Group
For the Group as a whole, turnover of £1,942.8m compared with £2,120.7m last year. At constant currency, turnover declined by 5.1%. The impact of currency movements lowered turnover by a further 3.3%, with the weakening of the US Dollar against Sterling having a particularly negative impact on reported numbers.

This decline in Group turnover at constant currency was entirely driven by the 7.4% decline in constant currency turnover at EMI Music. EMI Music Publishing grew turnover by 4.9% at constant currency.

Group operating margin increased to 12.0% from 11.8% in the prior year despite the decline in turnover. Operating profit before exceptional items and amortisation (EBITA) was £232.9m compared with £249.3m last year. The Group is not reporting any operating exceptional charges for the year. At constant currency, EBITA declined by 3.5%.

Group profit before tax, amortisation and exceptional items (Adjusted PBT) was £141.9m. The net result after taxation, amortisation, exceptional items and minority interests was a profit of £56.3m compared to a loss of £71.6m in the prior year.

Net debt increased to £829.5m from £748.7m in the prior year. This increase, in part, reflects the £60.3m one-off exceptional cash cost of outsourcing our manufacturing in Europe and the United States and of restructuring some of our labels and the artist roster together with the £42.3m cash cost associated with the acquisition of the remaining 20% of the Jobete song catalogue in April 2004.

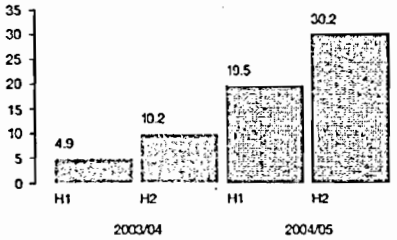
On a per share basis, adjusted earnings decreased to 13.5p from 15.8p in the prior year. On a fully diluted share basis, adjusted earnings were 13.0p.

The Board is recommending a final dividend of 6.0p per share, maintaining a full-year dividend of 8.0p per share and reflecting our continued confidence in the performance of, and outlook for, the business.

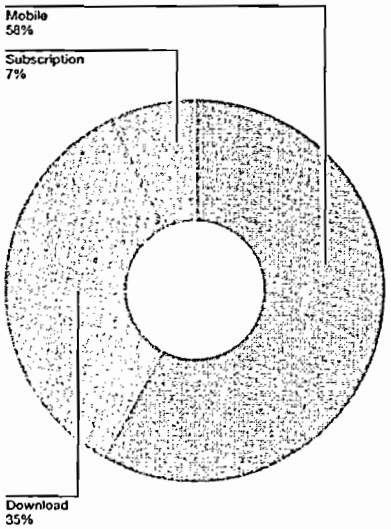
EMI Music
In spite of the improved market backdrop, EMI Music had a challenging year resulting in a disappointing performance. EMI Music delivered turnover of £1,542.1m compared with £1,722.8m in the prior year. At constant currency, turnover declined by 7.4%.

'A key driver has been the rapid growth in digital music.'

Total group digital sales
(£m at constant currency)



Group digital sales by revenue type



Operating profit (EBITA) was £132.7m compared to £147.4m in the prior year. Effective cost management and the realisation of cost savings from the outsourcing of manufacturing in Europe and the United States and the restructuring of some labels and the artist roster, resulted in the operating margin, before central costs, being maintained at 8.6%.

We saw a significant turnaround in our Continental European business, which enjoyed gains in market share and a major improvement in profitability for the year. Our North American business lost market share, following a successful prior year. We believe this to be a temporary setback and remain committed to continuing the turnaround seen in this region in prior periods. Japan also lost share, largely due to a lighter release schedule and, in particular, the lack of new releases from local superstars. Despite the rescheduling of albums from Coldplay and Gorillaz, the UK delivered a solid performance during the year, reflecting a steady stream of good releases.

EMI Music Publishing
EMI Music Publishing had a very strong year reporting turnover of £400.7m compared to £397.9m, an increase of 4.9% at constant currency.

Operating profit (EBITA) was £100.2m compared to £101.9m in the prior year.

EMI Music Publishing's performance demonstrated the superiority of our song catalogue, creative approach, marketing capabilities and operating efficiency. In particular, through the aggressive marketing of our songs, performance and synchronisation revenues continued to be important drivers of growth during the year as mechanical revenues remained under pressure.

Content protection
We continue to be extremely active in our fight against piracy. During the year, we saw industry lawsuits against illegal file sharers launched across Europe, in addition to those in the US, bringing the total number of lawsuits initiated internationally to nearly 12,000.

The IFPI (the worldwide recording association) has published evidence to indicate that our initiatives are having an impact. Overall, the number of infringing music files on the Internet has dropped from a peak of 1.1 billion, in April 2003, to 870m, in January 2005, a drop of 21%. This decline is even more impressive given that, during the same time period, global broadband penetration, a facilitator of online piracy as well as legitimate digital distribution, grew by 75% from 80m to 140m households worldwide. KaZaA, which used to be the largest and most popular file-sharing service, has seen its user figures drop by approximately 45% (from 4.2m to 2.3m average concurrent users) since the start of the warning and litigation campaign.

Our anti-piracy effort has included, and will continue to include, many initiatives in addition to lawsuits. We are also working closely with governments around the world to introduce and enforce copyright protection. Above all, we believe that the introduction of new and exciting legitimate digital music consumer offerings is a critical element in the fight against piracy.

‘Both businesses will benefit from improving long-term recorded music market trends, driven by continued strong growth in digital music.’

Management
In January, we announced a succession plan for EMI Music Publishing and the appointment of a new Group Chief Financial Officer.

Roger Faxon, who was the Group’s CFO, returned to EMI Music Publishing where he is now President and Chief Operating Officer. Roger is to become joint CEO of EMI Music Publishing, with Martin Bandier, in April 2006 and sole CEO in April 2007 when Martin Bandier will become full-time Chairman. In 2008, Roger will succeed Martin Bandier as Chairman and Martin Bandier will act as a consultant to the division for a further three years. With this, I believe we have in place a plan that will ensure a smooth succession and that will enable the EMI Music Publishing management team to continue to drive the business forward. I would like to thank Roger for the enormous contribution that he has made in his three years as Group CFO and on the Board.

Martin Stewart has taken up the position of Group CFO and, on 1 February 2005, was appointed to the Board of EMI when Roger stood down. I am very pleased to be working with Martin and believe that we have attracted an outstanding executive, with a strong track record in the media sector, and someone who has the talent to help us take the Group to the next level of performance.

In what has been a challenging year for the Group, on behalf of the Board I would like to thank all of my EMI colleagues for their hard work and on-going dedication and commitment to the business. I would also like to thank all our stakeholders for their support and, in particular, acknowledge the remarkable creative accomplishments of the artists and songwriters associated with our Company.

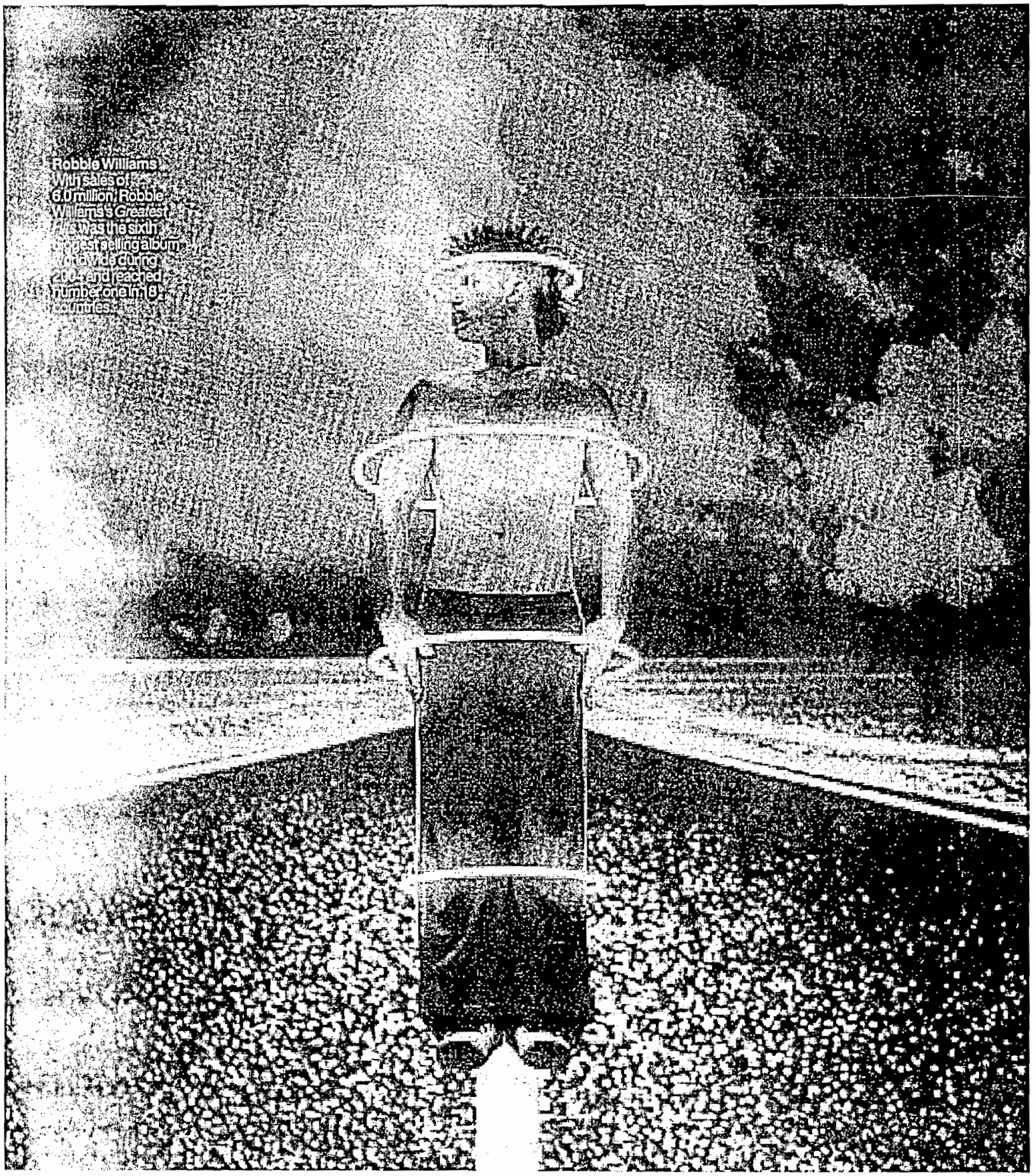
Outlook
Looking to the year ahead, we remain positive on the outlook for the music industry and expect to deliver an improved performance. EMI Music’s portfolio of releases should drive market share gain and increased profitability. The positive momentum at EMI Music Publishing should continue. Both businesses will benefit from improving long-term recorded music market trends, driven by continued strong growth in digital music.

Eric Nicoli
Chairman

Sample.

An estimated 50 million portable music players were sold worldwide in 2004.

Source: IDC



Robbie Williams
With sales of 6.0 million, Robbie Williams's Greatest Hits was the sixth biggest selling album worldwide during 2004 and reached number one in 8 countries.

Operating review: EMI Music

[illegible] Levy
[illegible] and CEO
[illegible]

[illegible]
[illegible] & Soul
[illegible] sions
[illegible]

[illegible] Turner
[illegible] Best
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Market overview
EMI Music continues to operate in a marketplace that is undergoing significant change, primarily driven by the rapid development of digital music. Market trends during the financial year lead us to remain positive on the outlook for the global recorded music market and optimistic about the opportunities digital will continue to bring.

The global recorded music market, combining physical and digital music sales, declined by only an estimated 1.0% during the year, a significant improvement on the 5.6% decline reported in the prior year.

While market conditions remain mixed by region, we have seen improving trends in physical music sales year-on-year in nearly all regions. Most encouraging has been the improvement seen in Continental Europe, particularly in the second half of the financial year. This improvement has been driven by a significant reduction in the rate of decline in the key German and French markets. We also saw a notable improvement in the Japanese and Latin American markets. The North American market softened during the year, particularly during our second half.

Music video continued to be a growing segment of the global physical industry, up 6.3% on the prior year. We see increasing market opportunities for higher value-added physical music product that delivers increased music content to consumers and we are working on the development and introduction of new formats and products, for example DualDisc.

Digital
The rate of development of the digital music marketplace during the year has been very rapid and reaffirms our confidence that digital music will represent a very significant proportion of our business in the coming years. Digital market development to date varies significantly by region, with mobile music products dominating the Asian markets, in particular Japan, downloads leading the North American market and a combination of both being seen in the UK and Continental Europe. We believe this variation will lessen in years to come largely as a result of the roll-out of technological advances.

Importantly, a number of large organisations recognise the digital music opportunity and have committed significant resources to drive forward the development of this marketplace, particularly in the form of marketing expenditure. Specifically, in the past year we saw the launch of iTunes in Europe, a new digital download and music subscription service from Yahoo! Music Unlimited in the US, MSN Music on a global basis, Vodafone live! with 3G in the UK, the relaunch of Napster and the introduction of Napster To Go and Rhapsody-To-Go.

As an owner of digital music content, we believe that EMI is extremely well positioned to capitalise on this growth. Our strategy remains to deliver our music content to consumers in any form, at any time and in any place. As such, we have been working very hard to put in place the right digital partnerships globally to ensure that, as well as maximising the digital opportunity, we also secure the right value for our exclusive music content. We are making good progress with our IT investment programme, which is designed to enable us to efficiently capture the increased revenue opportunities we see in the digital environment.

Note: All album sales quoted in the photo captions are for the financial year ended 31 March 2005 unless otherwise stated.

Kylie
Ultimate Kylie
1.4m

Blue
Best of
1.8m

Beastie Boys
To The 5 Boroughs
1.9m

EMI Music delivered digital sales of £35.6m for the financial year, an increase of more than 300% on the prior year with digital sales now representing 2.2% of total revenues.

Performance review
Despite this improved market backdrop, EMI Music had a challenging year because of, in part, the changes to the release schedule and the lower than anticipated reorders in the fourth quarter. This resulted in a disappointing second-half performance, with the portfolio underperforming both our own expectations and the global music market. For the year, EMI Music sales declined by 7.4% at constant currency and market share fell to 12.9% from 13.5% in the prior year. Prior year global market share has been restated to reflect exchange rate movements.

In particular, the change of release dates of two major albums, *X&Y* from Coldplay and *Demon Days* from Gorillaz, from the last financial year to the current financial year, had a significant impact on the results. While we tightly manage the release schedule, recording music is a creative process and there can be instances where changes to the release schedule may adversely affect results for a specific financial reporting period. Both albums will be released in the first quarter of the current financial year and are expected to be major sellers.

We also saw our major second-half releases underperforming, with reorder levels being lower than anticipated in the fourth quarter. We are confident that this is not a reflection of the broader portfolio and we have seen our more recent releases performing well including albums from Moby, Chemical Brothers, Faith Evans and Athlete.

The year had some notable successes. Robbie Williams' *Greatest Hits* was the best-selling album during the financial year, achieving sales of over 6m units. This album was hugely successful on a global basis and was number one in 18 countries. It was the industry's sixth best-selling album worldwide during 2004. In February 2005, Robbie Williams received the British music industry's award for the best song of the past quarter century for *Angels*. Robbie Williams is now recording his next album which is planned for release in the current financial year.

In 2004, Joss Stone developed into a global superstar. Her latest album, *Mind, Body & Soul*, has sold 2.8m units since its release in August and her first album, *The Soul Sessions*, also continued to sell well throughout the year. Joss Stone's enormous talent was further recognised when she received BRIT awards for British Female Solo Artist and British Urban Act.

Norah Jones's albums, *Feels Like Home* and *Come Away with Me*, both released in prior financial years, together sold nearly 4m units during the year.

The *Now* compilations enjoyed success both in the US (where *Now 17* sold 3.5m units) and in the UK and Europe (where three *Now* albums each sold more than 1m units).

As a music-content company, artist and repertoire (A&R) is core to our business and is a key focus for us. Our strategy has been, and continues to be, the development of long-term career artists who will enjoy success on a multiple-album basis. During the

‘Our strategy is to develop long-term career artists with multiple-album success.’

Ray Charles
Genius Loves Company
1.3m

Lenny Kravitz
Baptism
1.3m

Keith Urban
Be Here
1.3m
Golden Road
1.0m

Yellowcard
Ocean Avenue
1.2m

year, we built upon the initial success of new superstars, Joss Stone, Keith Urban and Yellowcard, all of whom we believe will have long, productive and successful careers.

Through breaking new artists, we are continually strengthening our active roster of global superstars, which now amounts to nearly 50 artists including Robbie Williams, Coldplay, Norah Jones, Kylie Minogue, Moby, Lenny Kravitz, Daft Punk, Gorillaz, Beastie Boys, Paul McCartney, the Rolling Stones, Tina Turner and Hikaru Utada.

During the year, we continued to focus on superior catalogue marketing, maximising the revenues of our exceptional catalogue of recordings. *Dino: The Essential Dean Martin*, which sold 1m units during the year, is a good example of our ability to repackage prior recordings into new, compelling works. Other top-selling catalogue albums were The Beatles' *1* and The Beach Boys' *The Sounds of Summer*.

Geographic review

North America
Our North American business had a challenging year, following a very successful prior year, resulting in a loss of market share. This disappointing performance in part reflects the slippage of albums from Coldplay and Gorillaz and, also, a number of releases selling less than we had anticipated. Top-selling albums for the year included those from Beastie Boys, Keith Urban, Yellowcard, Chingy, Joss Stone and Anita Baker.

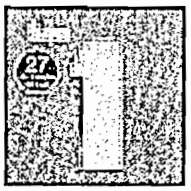
Digital music sales in North America more than doubled during the year. The market continued to be dominated by digital track downloads which, according to Soundscan data, now represent more than 4% of the total US music market in terms of unit sales on an album-equivalent basis. This is broadly in line with the proportion of EMI Music's digital sales in the region. Apple's hugely successful iPod and iTunes continued to drive market development. We have also seen the launch of other digital services including a download service from Microsoft, MSN Music, and subscription-based services such as Napster To Go and Yahoo! Music Unlimited. Mobile music remains relatively undeveloped but we expect this to change with advances in mobile technology in the region.

We continue to focus on building the breadth and depth of our North American artist roster. During the year, we created a new division at our Virgin label, Virgin Records Urban Music, which is headed by the proven hit-maker and producer, Jermaine Dupri. This will add to our range of creative sources in North America which includes the Capitol, Christian Music Group, Capitol Nashville and Blue Note labels.

EMI recognises that building its North American roster and repositioning the business is a multi-year effort which began to show some promising results in the prior financial year. We view the past year's sales performance as a temporary setback; the business remains profitable and we feel that our record labels are on the right path creatively. The current financial year has got off to a good start with, in particular, strongly performing releases from Dierks Bentley and Faith Evans.

The Beach Boys
Sounds of Summer
0.9m

Chingy
Powerballin'
1.1m



© Apple Corps Ltd

The Beatles
1
1.1m

UK & Ireland

The UK & Ireland business gained market share during the year reflecting a consistent stream of good releases. This included successful albums from established artists, such as Robbie Williams, Kylie Minogue, Phil Collins, Blue, Tina Turner and Chemical Brothers, as well as those from developing artists, such as Joss Stone, Athlete and Jamelia.

The overall regional performance was impacted by the change in release timings of albums from Coldplay and Gorillaz, both repertoire from the UK & Ireland business.

Digital saw massive growth in the UK during the year, driven by the launch of iTunes in June 2004 and the development of the mobile music market. In October, EMI Music agreed a deal with The Carphone Warehouse, which made Robbie Williams the first-ever artist to release an entire album plus video content on a memory card that slots straight into a mobile phone. This deal is just one example of the new and exciting music formats and opportunities digital music brings.

Continental Europe

Our Continental European business had a good year, gaining market share and significantly increasing its level of profitability. After a number of very challenging years, we are seeing the benefits from our restructuring initiatives in this region, strengthening what has traditionally been a very solid base for EMI.

In particular, our Italian business went from strength to strength with significant market share gains during the year. Albums from local artists, Vasco Rossi and Tiziano Ferro, were both major sellers. We also enjoyed good market share gains in France and Spain reflecting, in part, the successful implementation of our restructuring initiatives.

Other major-selling albums from local artists included Cali from France, Amaral from Spain and Wir Sind Helden and Helmut Lotti from Germany. Top-selling international artists included Robbie Williams, Blue, Tina Turner, Norah Jones, Moby, Joss Stone and Kylie Minogue.

We have seen strong growth in digital in Continental Europe during the year. In this region, digital sales are predominantly from downloads although we are seeing a good contribution from mobile music products, with a higher proportion than in the US and the UK.

Dean Martin
Dino: The Essential Dean Martin
1.0m

Moby
Hotel
0.9m

S.H.E
Encore
0.9m

Japan

Japan saw a decline in market share for the year, largely as a result of a lighter release schedule and, in particular, the lack of new releases from local superstars. During the year we have taken a number of steps to broaden our Japanese roster and increase the development of new local talent. As always, roster development takes time.

Major sellers during the year included a new release from Nori Makihara, new singles collections from Glay and Yaida Hitomi, and good sell through on Hikaru Utada's singles collection. Top-selling international artists included Beastie Boys, Blue and Norah Jones.

The digital market grew significantly during the year driven by the rapid development of ring tune penetration in the mobile phone market. The launch of new mobile products, such as ring backs and ring videos, provided exciting new consumer offerings.

South East Asia

South East Asia benefited from improving market conditions during the year but this was largely offset by a modest loss in market share. China saw a very significant increase in sales, reflecting aggressive development of local repertoire. We expect China to be a key growth driver for the region in the coming years.

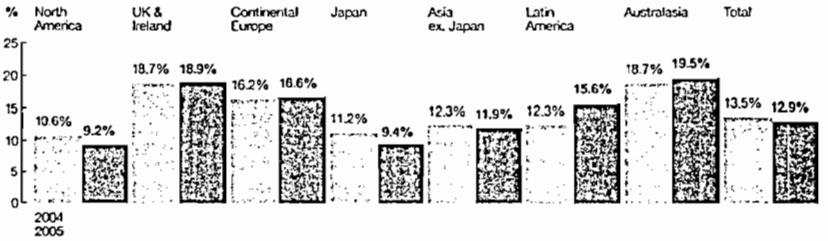
Major-selling local artists during the year included S.H.E., David Tao, ADA Band, Rene Liu and Elva Hsiao. Top-selling international artists included Robbie Williams, Norah Jones and Blue.

Australasia

Our Australasian business gained market share during the year but overall performance was impacted by difficult market conditions. Success in the region during the year was driven by strong local releases including albums from Jet, Missy Higgins and Kasey Chambers. Top-selling international artists included Robbie Williams, Norah Jones and Joss Stone.

The digital market in Australasia remains relatively immature, with the launch of iTunes eagerly awaited and the expansion of the telecoms networks to 3G still to happen.

EMI market share by region
Value (%)



Note: EMI share of wholesale including audio and music video products

‘Our focus is on developing both local and global artists with representation in all genres.’

Nigel Kennedy
Added success with a[illegible] in France.

Leif Ove Andsnes
Pop p[illegible] award for cla[illegible] release.

Latin America
Latin America had a very good year with market conditions greatly improved and EMI gaining significant market share. Strong sales growth resulted in the region returning to profitability during the year. Mexico, Argentina and Colombia were key growth drivers of the business.

Major-selling local artists during the year included Intocable, RDB, Quintanilla III, Legiao Urbana and Aleks Syntek. Top-selling international artists included Robbie Williams and Tiziano Ferro.

EMI Classics
EMI Classics made good progress during the year. Notable achievements were breaking Nigel Kennedy to gold status in France and the re-signing of Russian superstar violinist, Maxim Vengerov, who is about to record the Beethoven *Concerto* with Maestro Rostropovich and the London Symphony Orchestra.

Karl Jenkins signed a long-term contract with EMI Classics and his first two classical albums both went to the top of the UK classical charts. His *The Armed Man: A Mass For Peace* was the first album from a British contemporary classical composer to be certified gold in the UK in over a decade.

Leif Ove Andsnes broke into the pop charts with a platinum certification for his album Mozart *Piano Concertos Nos. 9 and 18* in his homeland, Norway, and Sir Simon Rattle and the Berlin Philharmonic Orchestra built on their reputation as the world's leading conductor and orchestra with a successful tour of Japan and South East Asia.

Norah Jones: *Feels Like Home* and *Come Away With Me* have sold nearly 30 million after notching up another 2.1 million and 1.8 million respectively this year. Norah is signed both to EMI Music's Blue Note Records and EMI Music Publishing.

Usher
Signed to EMI Music Publishing since the start of his career, last year was the most successful ever for Usher with a string of awards and the world's best-selling album in 2004, *Confessions*.

Operating review: EMI Music Publishing

Martin Bandier
Chairman and CEO
EMI Music Publishing

EMI Music Publishing continued its strong track record of achievement, delivering constant currency sales growth of 4.9% for the financial year. Given the backdrop of a changing and still challenging global music market, this performance demonstrated the superiority of EMI Music Publishing's song catalogue, creative approach, marketing capabilities and operating efficiency. These important attributes position us to take advantage of all of the new and growing uses of songs that are emerging around the world.

As always, a broad range of songs – both current hits and classics created years ago – contributed to this year's performance. Notable successes from recent releases included songs by Natasha Bedingfield, Jamie Cullum, Eminem, Good Charlotte, Alan Jackson, Jay-Z, Kelis, Alicia Keys, Kylie Minogue, Scissor Sisters, Jessica Simpson, Usher, Hikaru Utada, Kanye West and Pharrell Williams.

Through aggressive marketing of our songs, performance and synchronisation revenues continued to be important drivers of growth as mechanical revenues remained under pressure from industry conditions. We also benefited from our continued focus on improving collection efficiency from users and the national collection societies and ensuring proper payment for the use of our copyrights. The use of songs in digital applications, such as ring tones, continued to generate high rates of growth.

Pharrell Williams

Eminem

Regionally, our North American business continued to deliver good sales gains on a local currency basis. Through our effective song marketing approach, we once again achieved double-digit growth in synchronisation revenue in this business. Our UK business generated revenue gains in all income types, most notably in performance and mechanical revenue reflective of the high chart-share positions achieved in the last year. Sales in Continental Europe were marginally higher than last year at constant currency but mechanical revenues were under pressure in territories such as France, Germany, Spain and Scandinavia, where the recorded music industry remained especially difficult. In Japan, we generated attractive overall sales growth on a local currency basis, driven by gains in synchronisation income as well as higher mechanical income, largely due to the Queen *Jewels* collection and Hikaru Utada.

Sting

Mechanical revenue

Mechanical royalties, derived primarily from the sales of recorded music products, now represent less than 45% of our total publishing revenues, down from over 56% of the total five years ago. Mechanical revenues declined by 6.3% at constant currency for the year. Given the time lag in receiving royalties from collection societies, mechanical revenues were negatively affected by the prior period's decline in the global recorded music market and the phasing of receipts.

‘We continued our strong track record, growing sales by 4.9%.’

Alan Jackson

Jay-Z

Kayne West

Scissor Sisters

Queen

Ashlee Simpson

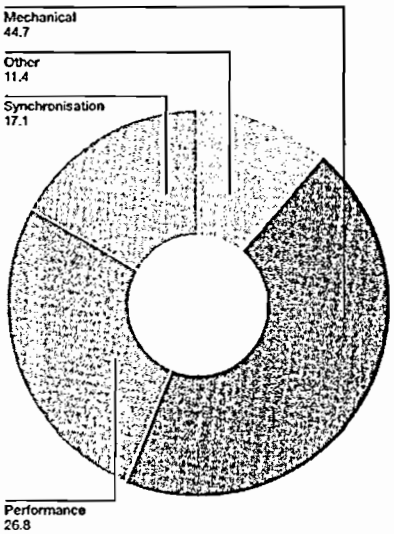
Performance revenue
Performance revenues, earned when a song is performed live on stage, played in a bar or broadcast on the radio or television, grew by 7.7% at constant currency for the year. This high growth was driven by a range of factors including continued expansion of media outlets and channels around the world, improved tracking and collection efforts and strong chart positions for our songs, particularly in pop and urban music. Performance revenues have been a source of growth for EMI in each of the past seven years and this income type now contributes almost 27% of total publishing revenues.

Synchronisation revenue
Our synchronisation revenues continued to generate attractive growth, increasing by 13.2% at constant currency for the year. Synchronisation revenue is generated by the use of songs in audiovisual works such as advertisements, television programmes, films, computer games and in mobile phones. Important synchronisation licences for advertising were signed with companies including General Electric, Philips Electronics, Fisher Price, Pepsi, Maxwell House Coffee and Renault. Recent successes in licensing our songs to television programmes included: *American Idol*, *The CBS Early Show*, *CSI*, *One Tree Hill* and the *OC* and to films such as: *Bridget Jones: The Edge of Reason*, *Coach Carter*, *Hitch*, *Shark Tale*, *Spider Man 2* and *Shrek 2*.

These successes demonstrate that we have continued to achieve effective execution of our strategy of combining a strong customer orientation with a superior understanding of how our songs can improve an audiovisual work. This proactive approach has enabled us to be the best at meeting the creative needs of content creators and music producers. Our synchronisation revenue has grown consecutively for more than ten years and this category now represents over 17% of our total publishing revenues.

Other revenue
Other revenue, which includes income from uses such as print, stage productions, background library, some ring tones and other miscellaneous uses, increased by £15.8m and currently represents less than 12% of revenues. Important drivers of growth in other revenue during the year have been ring tones, stage productions such as *Mamma Mia* and *We Will Rock You*, and payments from enforcing the use of our copyrights.

Music publishing
Revenue sources
(%)



Digital

The use of songs in new digital applications is an attractive and fast-growing opportunity. Our digital sales grew sharply during the year, contributing over £14m to our revenues, and were up 90% at constant currency from the prior year. Digital revenues now represent 3.4% of EMI Music Publishing's total revenues, compared to 2% in the prior year. Revenues from digital music are currently classified amongst the various revenue categories – mechanical, performance, synchronisation and other – based on the varying status of these new uses in different countries.

The use of songs in mobile phones, particularly via ring tones, continued to be the most significant early digital revenue contributor. Consumer acceptance of these new musical products has been very positive, with especially high interest in Asia and, increasingly, in Europe. In the US, mobile song use is at a relatively early stage with the potential for very attractive growth in the coming years as phone and compression technologies improve.

EMI Music Publishing has continued to be at the forefront of maximising royalty generation from digital music products. In December, EMI finalised an agreement with Sony BMG that will facilitate the introduction of a wide range of digital offerings in North America. Ground-breaking agreements such as this are instrumental in driving new digital music product development. The collection societies play an important role in ensuring that publishers and songwriters fully benefit from the many new digital uses. EMI has been working to focus these third parties on faster identification of new product offerings, rate setting and royalty collection from the varied digital song customers.

Progress with some of these third parties has been slower than desired, with the development of the necessary reporting systems still at an early stage.

We are well positioned to benefit from the anticipated global growth of other digital song uses such as music and video downloads, subscription services, ring tunes and ring backs. We already have an extensive global network and effective song-based royalty processing systems that, together with our high quality song catalogue, enable us to grow flexibly as each type of digital product gains acceptance.

Key organisational initiatives

We have continued to strengthen our management team during the year. Most notably, Roger Faxon returned to EMI Music Publishing in February, to take on the newly created role of President and Chief Operating Officer. Roger has extensive experience at EMI, both at music publishing and in corporate management roles, as well as within the entertainment industry.

Jamie Cullum

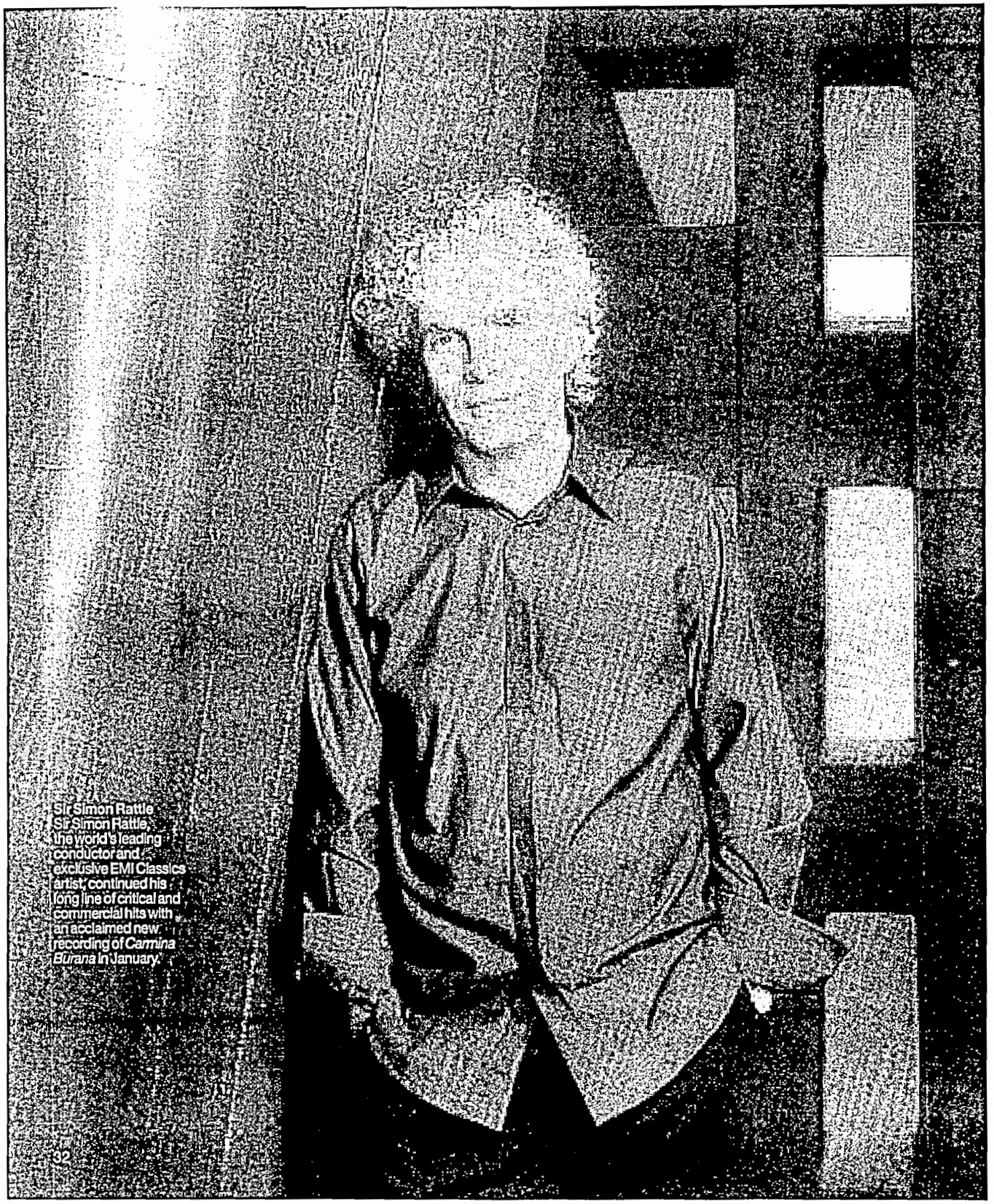
Natasha Bedingfield

Alicia Keys
Signed to EMI Music Publishing in 1996 when just 15 years old, Alicia Keys received [illegible] Grammys this year [illegible] current album, [illegible] platinum *The Diary of Alicia Keys*, adding to the [illegible] on in 2002 [illegible] debut.

Browse.

Broadband subscriptions reached 145 million worldwide by the end of 2004.

Source: Quantum-Web



Sir Simon Rattle
Sir Simon Rattle, the world's leading conductor and exclusive EMI Classics artist, continued his long line of critical and commercial hits with an acclaimed new recording of *Carmina Burana* in January.

Financial review

Martin Stewart
Chief Financial Officer
EMI Group

Turnover
Reported Group turnover fell by 8.4% or £177.9m to £1,942.8m. The decline, excluding exchange movement, was 5.1% or £107.1m. The adverse exchange movement was largely driven by a decline in the weighted average rate of the US Dollar against Sterling from $1.70 last year to $1.85 in 2004/05.

At constant currency, turnover in EMI Music fell by 7.4%, declining in all regions apart from Latin America. The disappointing level of reorders for second-half releases and the slippage of two major albums out of the financial year was partially offset by stronger catalogue sales.

At constant currency, turnover in EMI Music Publishing was up on the prior year in all major geographic regions and by 4.9% at a divisional level. The increase in turnover was driven by strong growth in performance, synchronisation and other revenues. Mechanical revenues were below the prior year, driven by the decline in the global recorded music market.

Group digital sales increased to £49.7m from £15.1m in the prior year, an increase of 329% at constant currency. Digital sales represented 2.5% of total Group turnover for the year, with the percentage increasing sequentially during the year from 2.2% in the first quarter to 3.5% in the fourth quarter.

Costs
During the course of the year, all costs were tightly controlled. Administration expenses were reduced by £31.6m and gross margin, after distribution costs, improved from 35.3% to 35.7%.

Royalty and copyright costs, manufacturing and distribution costs together with marketing and promotion costs are all largely variable with turnover. They have, therefore, declined in absolute terms but, as a result of greater efficiencies, there has been a relative improvement particularly in marketing and promotion costs. Group corporate costs were higher in the year due to increased legal and regulatory costs.

The cost structure was improved over the year by the outsourcing of manufacturing in the United States and Europe and the restructuring of some of our record labels, particularly in Continental Europe. These initiatives delivered savings of £35m in the year and are expected to deliver further savings of £15m in the current financial year, bringing the total annualised cost savings to £50m.

'Costs were tightly controlled and gross margin improved to 35.7%.'

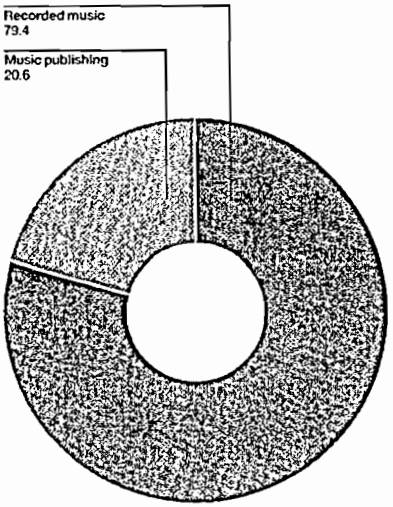
Operating profit
Group operating profit (EBITA) declined by £16.4m or 6.6% from £249.3m to £232.9m. Excluding exchange the decline in EBITA was £8.7m or 3.5%.

EMI Music reported EBITA of £132.7m, a decline of £11.8m or 8.0% at constant currency on the prior year. The EBITA contribution from the Continental Europe region increased significantly in the year but this improvement was more than offset by declines in North America and Asia. Operating margin remained constant at 8.6%, further evidence of the Group's determination not to chase unprofitable sales and its ability to control costs.

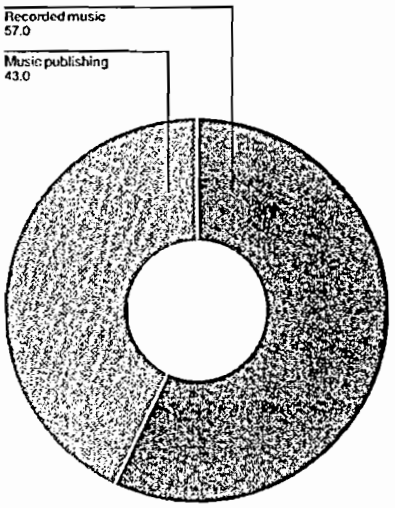
EMI Music Publishing reported EBITA of £100.2m, a growth of 3.0% at constant currency on the prior year. Operating margin declined from 25.6% to 25.0%. This decline in margin was primarily attributable to an increase in allocated corporate costs.

Group operating margin increased again from 11.8% to 12.0%.

Group turnover by business division (%)



Group operating profit by business division (%)



First half and second half comparison

Group turnover for the second half was down 5.9% from the same period last year. Excluding the effects of currency movements, the decline was only 4.7%. During this period, EMI Music Publishing turnover was up on last year in all regions at constant currency. On the same basis, EMI Music also showed growth over the second half in the UK & Ireland, in Continental Europe and in Latin America.

Group EBITA for the second half was down 9.5% from the same period last year. On a constant currency basis, second-half profits were down 8.7%. The divisional geographic comparisons followed the same pattern as turnover; EMI Music Publishing was up in all regions while EMI Music was up only in the UK & Ireland and Continental Europe.

Other items affecting earnings

Group finance charges excluding exceptionals rose by £6.2m to £92.1m. This reflected both a 2.3% increase in average net borrowings as well as increases in interest rates in both the UK and the US, two of our major funding territories.

Adjusted profit before tax fell from £163.3m to £141.9m, driven by the decline in turnover.

The Group tax rate, before amortisation and exceptional items, was 22% against 19.9% in the prior year. The increased rate reflected a movement in profitability towards countries in Continental Europe, where our marginal tax rate is higher, and away from the US, where there are brought-forward losses available for offset.

The charge in respect of the amortisation of copyrights and goodwill at £50.7m was slightly down from last year's total of £50.9m.

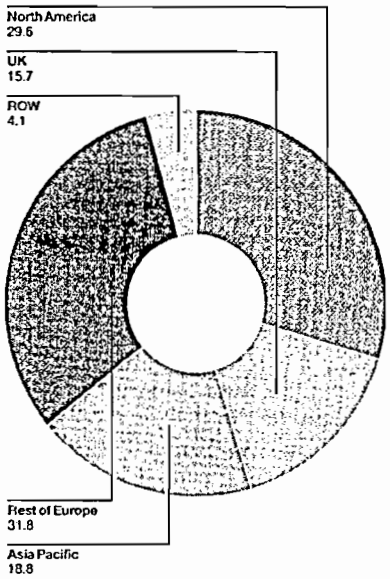
After material operating exceptional costs of £138.3m in 2003/04, there were no operating exceptional costs to report this year. Similarly, after taking non-operating exceptional costs of £16.5m in 2003/04, there was a credit in 2004/05 of £0.8m, being the profit on the sale of properties. There were no finance exceptional costs to report in 2004/05 in comparison with a charge of £10.2m in the previous year.

The minority interest cost has reversed from a credit of £0.9m in the previous year to a charge of £4.3m this year. This is the consequence of the recorded music business in Japan, in which there is a 45% minority, returning to profit after falling into losses after operating exceptional costs last year.

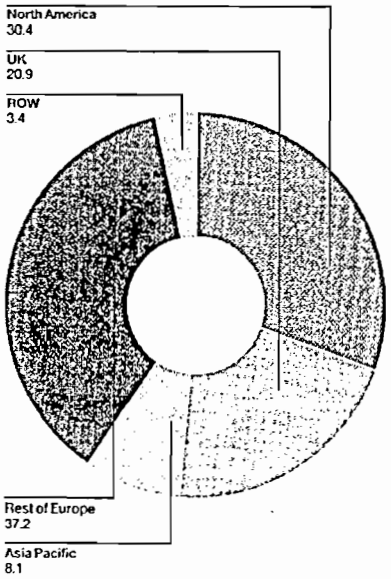
Profit attributable to members of the Holding Company was £56.3m against a loss last year of £71.6m.

Adjusted basic earnings per share were 13.5p, compared with 15.8p. On a diluted basis, treating outstanding convertible debt and outstanding share options as equity, adjusted earnings per share were 13.0p. The Board is recommending a final dividend of 6.0p per share to maintain the total dividend of 8.0p per share.

Group turnover by origin
(%)



Group operating profit by origin
(%)



Cash flow and net borrowings

Improvement in cash conversion and overall cash management remains a key area of focus for the Group. The net cash inflow from operating activities was £221.4m. This represented a significant reduction from last year's inflow of £309.4m, reflecting two primary factors. First, the reduced inflow comes after deducting £60.3m in respect of cash spend on the restructuring programmes announced on 31 March 2004. Secondly, the inflow from improved working capital management was £25.2m for the year, compared to £58.3m in the prior year.

After the net cash inflow from operating activities, we had cash outflows of £101.6m for finance charges, £32.7m for taxation, £108.5m for investment activity (notably the final payment of £42.3m in respect of Jobete and deferred consideration payments in respect of Mute and Hit and Run), and £62.9m for dividends, giving an overall cash outflow before exchange differences of £84.3m. Net of receipts from the issue of shares of £1.7m and a gain on translation of £1.8m, year-end net debt has increased by £80.8m, from £748.7m to £829.5m.

Pensions

EMI maintains a number of defined benefit plans around the world, the largest of which is in the UK As a consequence of the triennial valuation of that plan as at 31 March 2003, the Group resumed annual contributions in respect of future service to the UK fund with effect from 1 April 2004. This resulted in a cash cost of approximately £6.5m with no profit and loss impact due to the accounting treatment as determined by SSAP 24. These contributions will continue until the outcome of the next triennial valuation, as at 31 March 2006, is known and future funding requirements can be determined.

Treasury matters

Funding

On 15 July 2004, the Group signed an additional 364 day £100m committed credit facility with a group of banks. With this exception, the Group's funding sources have not changed during the year, following the major restructuring in the Autumn of 2003. In that restructuring, five interconnected programme components were implemented. The Group issued €425m 8.625% Senior Notes due 2013 and US$243.3m Guaranteed Convertible Bonds, due 2010 unless previously redeemed, converted or purchased and cancelled. The Group cancelled its existing short-term revolving credit bank facilities expiring 2005 and entered into a new £250m revolving credit facility expiring 2007. Finally, the Group prepaid US$56.25m Senior Notes due in 2009 and 2012.

The average term of the net debt at 31 March 2005 was 5.9 years against 7.1 years as at last year end.

'Improvement in cash conversion remains a key area of focus for the Group.'

Policy and risk
Treasury activity is carried out under a framework of policies and guidelines approved by the Board. The Board reviewed the policy framework during the year and approved the few changes proposed. Control and authority is delegated to the Treasury Management Committee, chaired by the Group Chief Financial Officer.

Financial instruments held by the Group comprise derivatives, borrowings, cash and liquid resources and other financial assets and liabilities, their purpose being to raise finance for the Group's operations. Treasury policies prohibit their use for speculative purposes.

The Group borrows in various currencies and uses swaps, caps and collars to manage interest rate exposure. The Group policy is that a minimum of 25% of the Group's term borrowings should be at fixed/capped rates.

The Group faces currency exposure from exchange rate fluctuation against Sterling. Balance sheet exposures are hedged to the extent that overseas liabilities, including borrowings, provide a natural hedge. Group policy is neither to undertake additional balance sheet hedging measures nor to hedge profit and loss account translation exposure. Transaction exposures are hedged, where there are material items that have a high probability of occurring, with the use of forward exchange rate contracts.

Adoption of International Financial Reporting Standards (IFRS)
The Group expects to publish its first financial statements under IFRS for the six months to 30 September 2005 and for the year ending 31 March 2006.

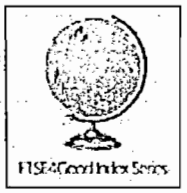
The Group intends to announce the impact of IFRS on its financial statements in early July. It is anticipated that the areas of most significant impact in 2005/06 will all be non-cash items and will comprise:

- the inclusion of the valuations of the defined benefit pension schemes, notably that in the UK, on the balance sheet together with additional information on equivalent service cost and financing cost in the Profit and loss account;
- other effects on financing charges including revaluation movements on our convertible bond and exchange movements on foreign currency denominated debt;
- the inclusion of share-based pay awards as an overhead cost; and
- the replacement of automatic amortisation of goodwill with annual impairment reviews.

Social responsibility
EMI is using Snocap's copyright management technology to enable consumers to share music legally on peer-to-peer networks.
Share.

Jamelia
Parlophone's R&B star Jamelia performed at the UK government's launch of its Music Manifesto at EMI's Abbey Road Studios. EMI is one of the sound recording companies of the Music Industry which supports music education in the UK.

Social responsibility



'We believe that our investment in staff should mirror our investment in artists – building for the long term.'

We believe it is important to run our company in a way which benefits the wider community as well as our shareholders, artists and employees.

We are committed to transparency in the area of Corporate Social Responsibility (CSR) and publish a full social responsibility report every year, which is made available on our website.

EMI continues to be included in both the Dow Jones Sustainability Index and FTSE4Good. This year, we achieved the number two and a 'best in class' ranking respectively in two European surveys of the media sector that were undertaken by socially responsible investment organisations Oekom and Storebrand. We were also named as one of *The Sunday Times* '100 Best Companies to Work For' and one of *Management Today*'s 'Most Admired Companies' for 2004.

The UK's Media CSR Forum, in which we have played an active role since its inception, has helped identify and define some of the key CSR issues for our sector. We will be using the findings of that work to develop our CSR programme going forward.

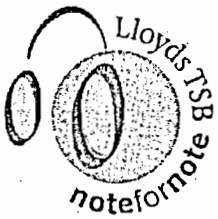
Employment
Our Social responsibility policy includes the key points of our employment policy framework – equal opportunity, health and safety, open communication and fair reward. Responsibility for management of employment matters rests with each business operation within that framework. We promote five key values in the company: creativity, integrity, accountability, adaptability and empowerment. Our Standards of Business Conduct reinforce aspects of integrity and accountability and are distributed across the company.

Creative businesses such as ours rely strongly on their people. We are working hard to ensure that our investment in staff mirrors our investment in artists by building for the long term. Two good examples of this are EMI Music UK and the Christian Music Group in the US, where all staff on the senior management teams have come up through the company. For the second year running, EMI Music UK was named as one of the '100 Best Companies to Work For' in an annual survey by *The Sunday Times*, moving up to 39th from 73rd position. The results are based on independent and confidential employee surveys covering a range of workplace issues; EMI was ranked in the top 10 for leadership, finding work stimulating and being proud to work for the company.

EMI continues to expand its worldwide management development programme, seeking out the talented people in the business and providing targeted workshops and development support. Approximately 15% of our executives received training this year in areas such as leadership and global thinking. These worldwide programmes are in addition to the training individual operating companies provide for their staff.

Our executive review programme, a formal performance management system first introduced three years ago, has now achieved a global uptake of over 90% and ensures that individual performance targets are set collaboratively with managers and are aligned to business strategy. It also drives training and development plans and is currently being introduced below executive level to enhance development of many more employees.

This is also the third year in which we have measured and reported on workforce diversity and health and safety. With a few exceptions, this information now covers our worldwide operations. Women made up 47% of all staff and 25% of management, ethnic minorities (excluding Asia and Latin America) made up 15% of all staff and 5% of management, and staff with disabilities represented 0.4% of staff and 0.3% of management.



During the year, we had 19 reportable injuries/illnesses (4.4 per 1,000 employees) based on UK standards and an average of 3.3 days' absence from illness per employee. We did not incur any health and safety enforcement notices or convictions.

Community

Our commitment to supporting music education and access to music produced a number of new initiatives during the year. In the UK, we continued our involvement in the development and implementation of the government's Music Manifesto, a strategy to enhance music provision in schools and the wider community. The Manifesto was launched by government ministers at Abbey Road Studios in July 2004, together with Sir George Martin and EMI artist Jamelia.

Keedie
EMI Classics artist Keedie with school children in London as part of the 'Note for Note' scheme.

Together with Yamaha, the BBC, The Prince's Trust and the Music Manifesto, EMI also became a partner in Lloyds TSB's 'Note for Note' – a new community-related marketing initiative launched by the UK bank. Note for Note's aim is to bring more music to schools nationwide; it will raise funds by inviting Lloyds TSB current account customers to 'round down' their credit balance to the nearest pound each month (or donate via their debit card). Customers can nominate up to two schools to receive their donations or choose the Music Boost Fund, which supports schools facing challenging circumstances. Schools can use the money raised for in-school workshops, Yamaha instruments and concert tickets and Lloyds TSB has committed £10m over the next three years to subsidise these offers.

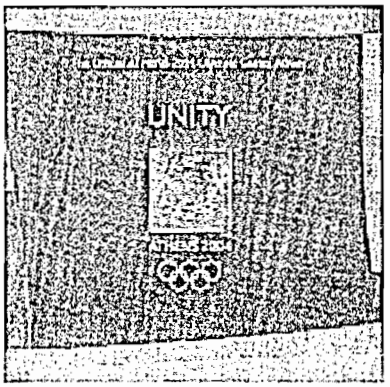
As part of our contribution to the programme, we produced *Bringing Music to your Classroom*, a DVD designed to be a useful teaching aid, which was sent to all 29,000 primary and secondary schools in Great Britain. It includes Simon Rattle's version of Britten's *A Young Person's Guide to the Orchestra* and a collection of interviews and videos from 12 of our classical and crossover artists. EMI Classics UK's artist Keedie was on hand at the Note for Note launch, performing and working with young primary school pupils. The EMI Music Sound Foundation (see below) is administering the programme's Music Boost Fund.

The EMI Music Sound Foundation, the independent charity we established in 1997, has now awarded a total of £2.3m to boost music education in the UK. The Foundation is the largest single sponsor of specialist performing arts schools and is now extending its support to the new category of specialist music schools; it also makes grants for instruments and training to individuals and to non-specialist schools as well as funding seven annual bursaries at music colleges in the UK and Ireland. More information can be found on www.emimusicsoundfoundation.com.

Teach First is a new UK programme that recruits top university graduates to teach for two years in under-resourced secondary schools, while also preparing them to succeed as long-term leaders in careers both inside and outside of education. In its first two years, it is estimated that the programme has made a positive impact on tens of thousands of pupils across 65 London schools. EMI is involved in several ways: providing support to Teach First in adding music teachers to the programme and then providing networking and industry engagement opportunities for them; offering participants summer work placements; and providing business and career coaching to second year participants as they decide what to do next.

In the US, EMI Music equipped a recording studio at the Bronx House in New York, a Music for Youth facility that runs an innovative after-school music programme. Having studio hardware and software installed on site will enable the young people who use Bronx House to do more than just learn about other people's music – now they can explore their creativity through making and recording their own music.

Smokie Norful
Grammy winner Smokie Norful with high school music students.



Unity
In association with the release of the *Unity* album, EMI donated £100,000 to UNICEF.

Swaziland
A choir in Swaziland perform at a UNICEF-backed concert which also featured EMI artist Mzwakhe Mbuli.

EMI in the US was also involved with the Grammy Jazz Ensembles Programme. In association with this year's Grammy awards, 29 talented high school students from the US and Canada travelled to Los Angeles where they met and performed with Grammy-nominated artists. The week included a recording session at EMI's Capitol Studios. While they were there, EMI Gospel artist and Grammy winner Smokie Norful paid them a visit to share some of his knowledge and experience.

The World of Nat King Cole was a CD and DVD linked to a television documentary and developed by EMI Music Marketing in the US for worldwide release; in conjunction with this, a $25,000 donation was made to the VH1 Save the Music Foundation, which is dedicated to restoring music programmes in schools across the country and raising awareness about the importance of music participation for young people.

Health and welfare is another area we support through our community investment and during the year we developed a partnership with UNICEF, the international children's charity. Initially this was through *Unity*, the official album of the Athens 2004 Olympic Games. In association with our release of this CD, EMI Music donated £100,000 to support HIV/AIDS work in sub-Saharan Africa. In January, EMI staff and South African artist Mzwakhe Mbuli joined a UNICEF team on a field trip to Swaziland, to see at first hand how UNICEF uses music and performance arts as a crucial education tool in the fight against HIV/AIDS.

We worked with UNICEF again after the devastating tsunami in Asia, setting up a scheme to match worldwide employee donations. The combination of staff giving, EMI's matching and an initial corporate donation raised more than £230,000 to help with both immediate relief and longer-term development in the affected areas.

To mark the untimely death of South African icon and EMI artist Brenda Fassie, EMI released worldwide a greatest hits compilation spanning her 20-year career. All profits were donated to 46664, the HIV/AIDS education and research arm of the Nelson Mandela Foundation.

EMI Australia has embraced community involvement as a key part of its social responsibility programme and this year launched 'department community days'. By year end, 75% of the company's departments had completed a day working together in the community and the remaining departments had identified their charity and planned the day. Beneficiaries ranged from a telephone/online counselling service for young people and a children's hospice to habitat preservation and restoration groups.

EMI's worldwide charitable cash donations for the year were £1.0m; this was complemented by additional community investment from participation in industry fundraising events around the world, arts sponsorship, staff time and gifts in kind. Based on our UK operations, we continued to achieve the PerCent Standard, a benchmark designed to recognise companies that invest a minimum of 1% of their pre-tax profits in the community.

Environment

We completed our exit from manufacturing in Europe and the US in June 2004. This leaves us with just two plants, in Japan and Canada, and a significant reduction in the environmental impacts that we can manage directly. As an example, our worldwide energy use dropped 44% compared to the previous year, almost entirely due to our exit from CD manufacturing.

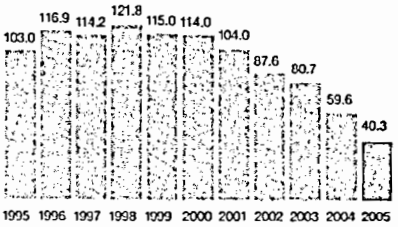
‘We aim to ensure that our indirect environmental impacts are managed as responsibly as those from our own facilities.’

We will continue to promote responsible environmental management in our offices, studios, distribution centres and remaining factories, and to report on our progress. We have also asked our CD suppliers in Europe and the US to give us an annual report covering the key performance indicators we use internally to manage the environmental impact of manufacturing. Our aim is to try to ensure that our indirect impacts in this area are managed as responsibly as those from our own facilities.

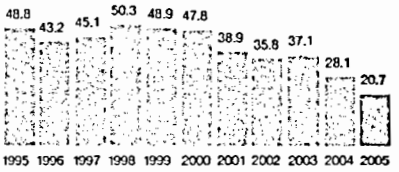
Worldwide, our carbon dioxide (CO_2) emissions from all our buildings dropped by 32% in absolute terms and by 26% when related to turnover. The reduction in CO_2 is less than the drop in energy use primarily because last year’s number reflected the use of renewable electricity at our Dutch manufacturing facility.

Within our remaining manufacturing operations we continued to track hazardous waste, solvent consumption and polycarbonate scrap, with all three showing reductions on a per unit basis compared to last year. The dramatic drop in hazardous waste (as shown in the graph) is due to the fact that, historically, the Dutch plant was required to classify a far greater range of wastes in this category. We continued our downward trend in solvent consumption, with a 21% reduction per unit produced. This was, however, approximately 9% above our target, largely due to purchasing solvent stocks late in the year, for use in the following year. Polycarbonate scrap dropped 6% per unit produced, exactly on target.

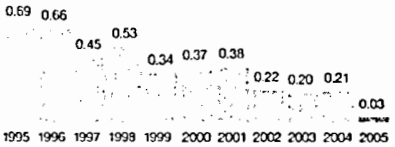
Global warming potential
CO_2 emitted due to energy use in buildings/factories (kilotonnes)



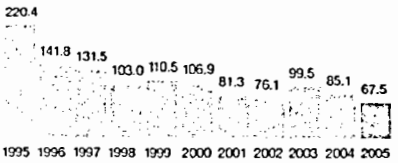
Global warming potential
CO_2 emitted due to energy use in buildings/factories per unit of turnover (tonnes/£m)



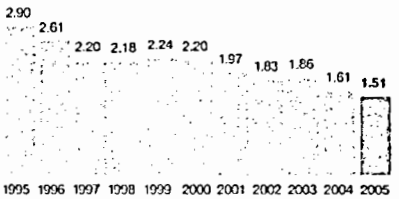
Hazardous waste
(tonnes/million units of output)



Solvent use
(litres/million units of output)



Polycarbonate scrap
(tonnes/million units of CD output)



Collect!

Executive directors

Eric Nicoli

Alain Levy

Martin Bandier

Martin Stewart

Eric Nicoli (54)
Chairman

Eric Nicoli was appointed to the Board in 1993 as a Non-executive Director, becoming executive Chairman in July 1999. Until 30 April 1999, he was Group Chief Executive of United Biscuits (Holdings) plc (UB), which he joined from Rowntree Mackintosh in 1980. He was appointed to the UB Board in 1989 and became Chief Executive of UB in 1991.

Mr Nicoli is: Non-executive Chairman of The Tussauds Group Ltd; Chairman of The PerCent Club, The EMI Group Archive Trust and of the Trustees of the EMI Music Sound Foundation; and a director of Creative and Cultural Industries Ltd.

Alain Levy (58)
Chairman and Chief Executive Officer
EMI Music

Alain Levy joined EMI and was appointed to the Board in October 2001.

Mr Levy joined CBS International (now Sony Music) in 1972 and, after 12 years, moved to PolyGram (now Universal Music Group), where he became President and CEO in 1991. In both companies he held various posts involving manufacturing, logistics, marketing and management. Mr Levy remained with PolyGram until it was sold to Seagram in 1998.

Mr Levy is a director of David Linley & Co. Ltd and Ilchester Investments Ltd. He also sits on the advisory board of Schroder Venture Partners LLC (formerly Schroder Ventures) in the US and on the European advisory board of Wharton Business School.

Martin Bandier (63)
Chairman and Chief Executive Officer
EMI Music Publishing

Martin Bandier was appointed to the Board in April 1998. He joined EMI Music Publishing as its Vice Chairman in 1989 upon the acquisition of SBK Entertainment World Inc. (SBK), in which he was a founding partner. He was appointed CEO of EMI Music Publishing in 1991 becoming, in addition, Chairman in 1992.

Mr Bandier entered the music publishing business in 1975 as a founding partner of the Entertainment Music Company and the Entertainment Television Company and, together with his partners, created SBK in 1986.

Mr Bandier is a director of the National Music Publishers' Association, the BMI Foundation, the Songwriters' Hall of Fame, the Rock and Roll Hall of Fame and the Syracuse University Board of Trustees. He is also a member of the National Academy of Recording Arts and Sciences.

Martin Stewart (41)
Chief Financial Officer (CFO)

Martin Stewart, who is a Chartered Accountant, was appointed CFO and became a member of the EMI Board on 1 February 2005, having joined EMI on 7 January 2005.

Before joining EMI, Mr Stewart was Chief Financial Officer of British Sky Broadcasting Group plc. He held this post from May 1998 until August 2004, having joined that company in 1996. Between 1991 and 1996, Mr Stewart was employed by PolyGram, latterly as Finance Director of PolyGram Filmed Entertainment.

Non-executive directors

John Gildersleeve

Sly Bailey

Peter Georgescu

David Londoner

Kathleen O'Donovan

John Gildersleeve (60)
Deputy Chairman and Senior Independent Non-executive Director

John Gildersleeve joined the Board in February 2004 when he also became Deputy Chairman and Senior Independent Non-executive Director.

Until February 2004, Mr Gildersleeve was the Commercial and Trading Director of Tesco plc. He joined Tesco in 1965 and became an executive director in 1984.

Mr Gildersleeve is also Non-executive Chairman of Gallaher Group plc and a non-executive director (Non-executive Chairman designate) of The Carphone Warehouse Group PLC.

Sly Bailey (43)
Sly Bailey joined the Board in April 2004.

Mrs Bailey is Chief Executive of Trinity Mirror plc, the UK's largest newspaper publisher. Between 1989 and 2003, Mrs Bailey held various executive posts with the IPC Media Group, joining the Board in 1994 and becoming Chief Executive of IPC Media in 1999. She led the sale of IPC to AOL Time Warner in 2001. From 1984 until 1989, Mrs Bailey worked in sales management for The Independent and The Guardian newspapers.

Mrs Bailey is a non-executive director of The Press Association Ltd. She is also the President of Newstraid, a charity for the distribution and retail news trade.

Peter Georgescu (66)
Peter Georgescu joined the Board in 2002.

Mr Georgescu is Chairman Emeritus of Young & Rubicam Inc., a network of commercial communications companies, having served as that company's Chairman and CEO from 1994 until January 2000.

In addition, Mr Georgescu is a director of Levi Strauss & Co., International Flavors & Fragrances Inc. and Toys "R" Us, Inc. He is also Vice Chairman of the directors of New York Presbyterian Hospital and is a member of the US Council on Foreign Relations.

David Londoner (68)
David Londoner joined the Board in 2003.

Mr Londoner, who is a Chartered Financial Analyst, is the General Partner of The North River Company, L.P., a family investment partnership. He spent most of his career at Schroder & Co. Inc., joining a predecessor firm, Wertheim & Co., in 1972 and leaving when it was sold in 2000.

Additionally, Mr Londoner is a director of Meredith Corporation and a trustee emeritus of the American Museum of the Moving Image.

Kathleen O'Donovan (48)
Kathleen O'Donovan joined the Board in 1997 and has chaired the Audit Committee since 1999.

Ms O'Donovan is a non-executive director of Prudential plc, Great Portland Estates PLC and O_2 plc (and serves on their audit committees) and is also chair of the Invensys pension fund. She will be standing down from the Court of the Bank of England and as chair of its audit committee at the end of her six-year term on 31 May 2005.

Directors' report

for the year ended 31 March 2005

The Chairman's statement, the Operating reviews and the Financial review in this Annual Report together contain details of the principal operations of the Group and their results during the year as well as likely future developments.

Dividends
An interim dividend of 2.0p per Ordinary Share was paid on 1 April 2005. The Board is recommending a final dividend of 6.0p per Ordinary Share, making a total of 8.0p (2004: 8.0p). The final dividend will be paid on 7 October 2005 to Ordinary Shareholders on the register as at the close of business on 9 September 2005, with the shares going ex-dividend on 7 September 2005.

Substantial shareholders
As at 20 May 2005, the Company had been notified of the following interests of 3% or more in its Ordinary Shares:

	No. of shares	% of capital held
The Capital Group Companies, Inc.	36,211,326	4.59
The Goldman Sachs Group Inc. and its subsidiaries	24,224,817	3.07
HBOS plc/Insight Investment Management Limited	38,510,121	4.88
Legal & General Investment Management Limited	27,861,886	3.53
Lehman Brothers International (Europe)	38,045,403	4.82
Prudential plc group of companies	39,992,458	5.06
Schroder Investment Management Limited	73,710,242	9.33
Wellington Management Company, LLP	71,453,854	9.05

Share capital
Changes in the Company's share capital during the year, and details of the authority for the Company to purchase its own Ordinary Shares as at 31 March 2005, are set out in Note 22 on page 91.

Employment policies
Information on the Group's employment policies is given on page 39.

Supplier payment policy
The Company negotiates payment terms with its suppliers on an individual basis, with the normal spread being payment at the end of the month following delivery plus 30 or 60 days. It is the Company's policy to settle the terms of payment when agreeing the terms of each transaction, to ensure that the suppliers are made aware of the terms, and to abide by them. The Company makes payments to its suppliers through its subsidiary, EMI Records Ltd. The number of days' purchases outstanding at 31 March 2005 is calculated at 48 days (2004: 45 days).

Charitable and political expenditure
Charitable, sponsorship and fundraising activities carried out during the year within the Group contributed £1.0m (2004: £1.1m) to charitable organisations and communities around the world. These included UK charitable donations amounting to £0.3m (2004: £0.3m) and £nil (2004: £0.1m) elsewhere in the European Union ('EU'). These donations were given to support charitable organisations and community initiatives in youth and education, arts and culture, and health and welfare.

It is the Group's policy not to make any donations to political parties or to incur any political expenditure, as those terms are defined in the Political Parties, Elections and Referendums Act 2000 ('PPERA'). No such donations were made nor was such expenditure incurred either in the UK, the rest of the EU or elsewhere during the year (2004: £nil).

Research and development ('R&D')
During the year, Group expenditure on R&D totalled £40,000 (2004: £100,000).

Directors
The present Directors of the Company are named on pages 44 and 45. Mrs S Bailey, having been appointed on 2 April 2004, was elected by shareholders at the 2004 Annual General Meeting ('AGM'). Dr H Einsmann retired as a Director at the conclusion of the 2004 AGM. Mr R C Faxon resigned as a Director on 31 January 2005. Mr M D Stewart was appointed as a Director on 1 February 2005. All the other Directors served throughout the year.

Mr A M J I Levy and Mr P A Georgescu retire by rotation at the AGM pursuant to Article 112(A) of the Company's Articles of Association and, being eligible, offer themselves for re-election. Mr Stewart retires at the AGM pursuant to Article 112(B) and, being eligible, offers himself for election. Biographical information relating to the Directors to be elected or re-elected at the AGM is set out on pages 44 and 45.

On 6 January 2005, the Company announced a succession plan for its Music Publishing division. On 1 February 2005, Mr Faxon left the Board and returned to EMI Music Publishing in New York to become its President and Chief Operating Officer, reporting to Mr M N Bandier. As from 1 April 2006, Mr Faxon will rejoin the Board when he becomes Joint Chief Executive Officer of EMI Music Publishing with Mr Bandier. At that time, Mr Bandier, who will continue as Chairman of EMI Music Publishing, will cease to be a Director of the Company. From 1 April 2007, Mr Faxon will become sole Chief Executive Officer of EMI Music Publishing with Mr Bandier remaining as full-time Chairman of the division until 31 March 2008.

No Director had a material interest in any contract of significance subsisting at the end of, or during, the year involving any Group company, other than by virtue of having a service contract. Details of Directors' interests in the shares of the Company are set out in the Remuneration Report on pages 61 to 64.

Under Article 177 of the Company's Articles of Association, the Company provides the Directors and officers of the Company, to the extent permitted by law, with an indemnity in respect of liabilities they may incur in connection with the performance of their duties. From 6 April 2005, UK company law was changed so as to allow companies to indemnify their directors against liability, including costs and damages awarded, in civil proceedings brought by third parties (described in the legislation as 'qualifying third party indemnities') and to fund in advance defence costs. The Company has been advised that with effect from 6 April 2005, Article 177 provided the benefit of a qualifying third party indemnity to each of its Directors.

At the forthcoming AGM, it is proposed to adopt new Articles which will reflect this as well as other recent changes in law and practice. A summary of the principal changes to the Articles is contained in the Notice of AGM accompanying this Annual Report.

Auditor
Resolutions to reappoint Ernst & Young LLP as the Company's auditor and authorising the Directors to determine its remuneration will be put to the forthcoming AGM.

Annual General Meeting
The 2005 AGM of the Company will be held at 2.30pm on Thursday, 14 July 2005 at The Queen Elizabeth II Conference Centre, Broad Sanctuary, Westminster, London SW1P 3EE. The Notice of AGM accompanies this Annual Report. In addition to the ordinary business of the meeting, resolutions will be put to shareholders to: give authority to the Directors to allot shares; give authority to the Directors to disapply pre-emption rights; give authority to the Company to purchase its own shares; adopt new Articles of Association and authorise a scrip dividend scheme. Also, in order to avoid an inadvertent breach of the law, resolutions will be put to shareholders seeking approval for political donations and expenditure. Further explanations of these matters are provided in the letter to shareholders that accompanies the Notice.

Electronic Proxy Appointment ('EPA')
EPA will again be available for this year's AGM. CREST members may also use the CREST electronic proxy appointment service. Further information regarding EPA is provided in the Notice of AGM and on the Proxy Form.

By Order of the Board
C P Ashcroft
Secretary
23 May 2005

Corporate governance

EMI is committed to high standards of corporate governance. The Board considers that the Company has complied throughout the year with the Code provisions set out in section 1 of the revised Combined Code on Corporate governance which was issued in July 2003 ('the Code'), except as regards the length of Directors' service contracts, which is discussed in the Remuneration report on pages 56 and 57, and the combination of the roles of Chairman and Chief Executive which is discussed below.

Ernst & Young LLP has reviewed the Company's statement as to its compliance with the Code, in so far as it relates to those parts of the Code which the UK Listing Authority specifies for review by the external auditor, and its report is set out on page 67.

The Code was revised for reporting years which began on or after 1 November 2003. The first of the Company's reporting years subject to the revised Code began on 1 April 2004 and is reported on in this Annual Report.

The remainder of this section, together with the Remuneration report, provides an explanation of how EMI applies the principles of good governance as set out in the revised Code.

The Board

As at 31 March 2005, the Board of EMI Group plc comprised nine Directors of whom four were Executive Directors. Following the appointment of Sly Bailey on 2 April 2004, there were six Non-executive Directors. However, on the retirement of Dr Harald Einsmann as a Director at the conclusion of the 2004 AGM, the number of Non-executive Directors returned to five.

All of the Non-executive Directors are considered to be independent of [illegible] and free from any business or other relationship that could materially interfere with the exercise of their independent judgement. The Nomination Committee has conducted an annual review as to whether the Non-executive Directors remain independent against the criteria set out in the revised Code. As reflected in their biographies, which [illegible] on pages 44 and 45, the Directors have a wide and [illegible] range of experience in multinational and consumer-orientated businesses, as well as an appropriately international spread.

Eric Nicoli is executive Chairman of the Company, which incorporates the role of chief executive officer. Day-to-day executive responsibility for the [illegible] of the Company's two main businesses lies with Alain Levy [illegible] Chairman and Chief Executive Officer, EMI Music, and Martin Bayfield [illegible] Chairman and Chief Executive Officer, EMI Music Publishing, who [illegible] report to Eric Nicoli.

In recent years, and as explained in previous Annual Reports, the Board has concluded that EMI has been best served by the CEOs of the recorded music and music publishing businesses reporting to an executive Chairman who complements their music industry experience and [illegible]. The Board has further concluded that the interposition of an [illegible] senior executive over the business CEOs would lead to unnecessary duplication, and diffusion of responsibility.

The Board considers that, for the present, the structure outlined above is the most effective for EMI and is in the best interests of both the Company and its shareholders. Furthermore, the Board considers that the nature and level of matters reserved for decision, either to the Board as a whole or to standing committees of the Board, appropriately limit the authority of the Chairman and reflect the combination of the posts of chairman and chief executive officer in one person.

It is the Board's policy that, so long as the Chairman is also the chief executive officer of the Company, the independent Non-executive Directors should comprise a numerical majority of the Board and that the senior independent Non-executive Director should also be either sole or joint Deputy Chairman.

Apart from EMI, Eric Nicoli's only other significant commitment during the year was the chairmanship of The Tussauds Group Limited, a private company.

The Board as a whole considers the appointment of Directors to, and executive appointments within, the Board, based on recommendations from the Nomination Committee which follows a formally approved selection process. The Articles of Association include a requirement that all Directors should submit themselves for election by the shareholders at the AGM immediately following their appointment and for re-election at least once every three years thereafter.

The Board meets at least eight times each year, with additional meetings or contact between meetings as necessary. The programme for each year is approved by the Board. Currently, the programme includes reviews of strategy together with the operations and results of the two main business units, as well as the approval of annual budgets and regular presentations on key business developments, major projects and strategic issues. Actual results for the Group and individual business units are reported to all Directors each month. In the year ended 31 March 2005, the Board met nine times, including a strategy review as part of its October meeting in New York. In coming years, the Board intends to meet at least twice each year outside the UK to allow closer contact with local management.

These procedures, together with other regular and ad hoc reports, aim to ensure that the Board is supplied in a timely manner with information that is appropriate to the discharge of its duties.

The Board's programme also includes management development and succession planning, reviews of the effectiveness of the Board and its principal committees, and an assessment of the performance of the Executive and Non-executive Directors conducted by the Chairman and the Non-executive Deputy Chairman. The review of the Chairman's performance is led by the Deputy Chairman and senior independent Non-executive Director. Additionally, the Board's programme provides for at least two meetings a year between the Chairman and the Non-executive Directors, as well as at least one meeting of the Non-executive Directors alone.

During the year, the effectiveness of the Board and its principal committees was assessed through each Director completing a questionnaire prepared by the Company Secretary and approved by the Chairman and Deputy Chairman. The results were then presented to the Board by the Company Secretary and, following discussion by the Board, agreed changes were implemented. A similar process was applied during the year by each of the Audit, Nomination and Remuneration Committees with the effectiveness questionnaire being approved by the Committee's Chairman. The performance of the Executive Directors and Non-executive Directors was reviewed by the Chairman and Non-executive Deputy Chairman, through completion of an appraisal form, and the results were communicated to the Directors concerned.

Tailored induction programmes are provided for new Directors. In addition to briefings by the Chairman, Company Secretary and Chief Financial Officer, meetings are arranged with a range of corporate and business executives as well as the external auditors and other advisers. Inductions also now include modular sessions covering topics such as key financial and other characteristics of, and operating risks faced by, the recorded music and music publishing businesses. The Board has also instituted a programme of ongoing professional development for Directors with modular sessions approved in advance by the Board.

The Board has delegated certain matters to standing committees, details of which are set out below. However, to ensure its overall control of the Company's affairs, the Board has reserved certain matters to itself for decision. These include the Group's strategic plans and annual operating budgets; significant acquisitions or disposals of companies, businesses or assets, and significant contractual commitments or items of expenditure; together with policies relating to the Group's treasury function, pensions, major litigation, employee share schemes, and environmental and ethical issues. The delegated authorities, together with each Committee's terms of reference and the schedule of matters reserved to the Board for decision, are reviewed each year.

All Directors have access to the services and advice of the Company Secretary, who is appointed by, and may only be removed by, the Board. The Company Secretary advises the Board on all governance matters, through the Chairman. There are also procedures for Directors, in appropriate circumstances, to obtain independent professional advice at the cost of the Company.

The Executive Directors are permitted to take external appointments as non-executive directors but usually only one such appointment may be with another publicly quoted company. They may retain the remuneration from such appointments. All appointments must be approved by the Board to ensure that they do not give rise to conflicts of interest.

The attendance by individual Directors at scheduled and ad hoc meetings of the Board and its Committees in the financial year ended 31 March 2005 was as follows:

Director	Board	Audit	Remuneration	Nomination	Executive
E L Nicoli	9(9)	4*	6*	3(3)	13(13)
M N Bandier	9(9)	n/a	n/a	n/a	12(13)
A M J H Levy	9(9)	n/a	n/a	n/a	12(13)
R C Faxon[a]	7(7)	3*	n/a	n/a	10(11)
M D Stewart[b]	2(2)	1*	n/a	n/a	2 (2)
J Gildersleeve	9(9)	4(4)	6(6)	3(3)	n/a
S Bailey[c]	9(9)	4(4)	6(0)	3(3)	n/a
H Einsmann[d]	2(4)	0(1)	1(3)	1(1)	n/a
P A Georgescu	8(9)	4(4)	6(6)	3(3)	n/a
D J Londoner	9(9)	4(4)	6(6)	3(3)	n/a
K A O'Donovan	8(9)	4(4)	6(6)	3(3)	n/a

Figures in brackets denote the maximum number of meetings that each Director could have attended.

* Not Committee members, but invited to attend all or part of the number of meetings indicated.

[a] Resigned on 31 January 2005.
[b] Appointed on 1 February 2005.
[c] Appointed on 2 April 2004.
[d] Retired on 13 July 2004.

Board committees

The principal committees of the Board are the Audit, Remuneration, Nomination and Executive Committees. Reflecting the important role played by the independent Non-executive Directors in ensuring high standards of corporate governance, all the Non-executive Directors are members of the Audit, Remuneration and Nomination Committees. Each committee has written terms of reference and levels of authority which have been amended so as to ensure compliance with the revised Code; these can be viewed on the Group's website, www.emigroup.com, or obtained on request from the Company Secretary. Except in the case of the Remuneration Committee, minutes of meetings are circulated to all Directors.

Remuneration Committee

The role of the Remuneration Committee, which is chaired by John Gildersleeve, is described on page 52. It meets at least three times each year. The Remuneration report on pages 52 to 64 gives information about the Directors' remuneration.

The main responsibilities and activities of the other three principal Committees are as follows:

Audit Committee

The Audit Committee is chaired by Kathleen O'Donovan and comprises all the independent Non-executive Directors. The Committee meets four times each year and its meetings are normally attended by the Executive Chairman, the Chief Financial Officer, the Group Financial Controller, the external auditor and the Head of Internal Audit. In addition, the Company Secretary & Group General Counsel attends in his capacity as secretary to the Committee. Separate meetings are held by the Committee with both the external auditor (at least twice each year) and the Head of Internal Audit (at least once each year) without the presence of Executive Directors or other management. Following each meeting the Committee Chairman reports to the Board any matter of particular importance.

The Committee is authorised to investigate any matter within its terms of reference and, where necessary, to obtain external legal or other independent professional advice. The Committee's responsibilities, which it has carried out during the year, include:

- reviewing, and assessing the effectiveness of, the Group's internal financial controls together with its internal control and risk management systems;
- making recommendations to the Board with regard to: the appointment, removal and remuneration of the external auditor; overseeing the Company's relations with the external auditor; monitoring the external auditor's independence and objectivity; and the effectiveness of the audit process;
- reviewing the internal audit plan for the year; monitoring and reviewing the effectiveness of the internal audit function; ensuring appropriate co-ordination between internal audit and the external auditor; providing adequate resources for the internal audit function and ensuring that it has appropriate standing; and approving the appointment or termination of appointment of the head of the internal audit function; and,
- reviewing the half-year and annual financial statements with particular reference to accounting policies; significant estimates and financial reporting judgements; and the disclosures made therein.

For each year, the Committee adopts a formal programme which is structured to coincide with key events in the Company's financial reporting cycle. The programme also includes other regular items, for example: a review of the Committee's own effectiveness and that of the internal audit function; a continuing programme of post-investment reviews; the Company's policy for the provision of non-audit services by the external auditor; reviews of material litigation to which the Group is party; a review of treasury policies and the Group's main pension plans; and the review and supervision of the Group's worldwide 'whistleblowing' arrangements. In addition, the Committee's programme during the last year has included regular reports on the Group's preparations for the implementation of International Financial Reporting Standards and an assessment of the effectiveness of the Internal Audit Department which was supported by a review conducted by external consultants.

Each year, the Committee reviews the independence and objectivity of the external auditor with a view to confirming that, in its opinion, the maintenance of objectivity on the one hand and value for money on the other have been kept appropriately in balance. During the past year the Committee has reconfirmed its detailed and formal policy regarding the provision of non-audit services by the external auditor. Services for which the external auditor may be considered under this policy include supporting and reporting on financial representations in public documentation and general advice on accounting and financial reporting matters. Services for which the external auditor may not be engaged, without the prior approval of the Audit Committee, include tax planning advice, employee tax services and consulting services.

Further details of the Committee's role in relation to the annual assessment of the Group's internal control framework are set out below.

Nomination Committee
Chaired by John Gildersleeve, the Committee comprises all the Non-executive Directors and the Chairman. The Committee makes recommendations to the Board on the appointment of Directors and the reappointment of Non-executive Directors on the expiry of their three-year terms of appointment. In addition, the Committee is responsible for making recommendations to the Board regarding plans for succession for both Executive and Non-executive Directors.

A formal process has been adopted by the Committee to make recommendations on both the appointment of new Directors and the re-election of existing Directors. This involves an evaluation of the skills, knowledge and experience of the Board as a whole, consideration of the need for the progressive refreshing of the Board and agreement of a description of the role and capabilities required for an anticipated new appointment. The selection process is led by the Chairman in close consultation with the Non-executive Deputy Chairman and all Directors are offered the opportunity to meet a potential appointee before the Committee meets to discuss the proposed recommendation.

In addition, the Committee reviews the structure, size and composition of the Board, and oversees the process for reviewing the effectiveness of the Board and its principal committees as well as the performance of individual Directors.

The Committee meets at least twice a year and otherwise when required. During the financial year ended 31 March 2005, the Committee met three times. It recommended: the succession plan for EMI Music Publishing involving Martin Bandier and Roger Faxon; and the appointment of Martin Stewart as Chief Financial Officer in succession to Roger Faxon. An external search agency was engaged in connection with the latter appointment of a new Director.

Executive Committee
Chaired by the Chairman, the Executive Committee also comprises the chief executive officers of the Company's two main businesses, together with the Chief Financial Officer. The Committee is responsible for the approval of acquisitions, divestments, capital expenditure and contractual commitments below the level that the Board has reserved to itself for decision, and for certain operational, administrative and other routine matters.

The Committee also regularly reviews and reports to the Board on the performance of the Group's businesses. At least twelve meetings are held by the Committee each year and senior Group executives frequently attend by invitation.

Directors' responsibilities
UK company law requires the Directors to prepare financial statements for each financial year which give a true and fair view of the state of affairs of the Company and the Group, as well as the profit or loss and cashflows of the Group for that period. In preparing those financial statements, the Directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and estimates that are reasonable and prudent; and,
- state whether applicable accounting standards have been followed, subject to any material departures disclosed and explained in the financial statements.

The Directors confirm that they have complied with these requirements in preparing the financial statements on pages 68 to 96.

The Directors are responsible for keeping proper accounting records which disclose, with reasonable accuracy at any time, the financial position of the Group and enable them to ensure that the financial statements comply with the Companies Act 1985. They are also responsible for safeguarding the assets of the Group and, hence, for taking reasonable steps for the prevention and detection of fraud and other irregularities.

Going concern
The Directors believe that, after making enquiries they consider to be appropriate, the Group has adequate resources to continue in operational existence for the foreseeable future. For this reason, they continue to adopt the going concern basis in preparing the financial statements.

Internal control
The Board is responsible for the Group's system of internal controls and for reviewing its effectiveness. The system of internal control is based on what the Board considers to be appropriate to the Group's activities, to the materiality of the financial and other risks inherent in those activities and to the relative costs and benefits of implementing specific controls. It is designed to manage, rather than eliminate, the risk of failure to achieve business objectives and, as such, provides reasonable, but not absolute, assurance against material misstatement and loss.

The full Board meets regularly throughout the year and the matters specifically reserved for its approval ensure that the Directors maintain control over significant strategic, financial and compliance matters.

The Group has an established organisational structure with clearly defined lines of responsibility and reporting. The Board has devolved to executive management responsibility for implementing and maintaining the Group's system of internal control. Each business unit operates in accordance with policies and procedures applicable to all of the Group's units.

The Group operates comprehensive annual planning, financial reporting and forecasting processes. The Board formally approves strategic plans and annual budgets. The Group's performance is monitored against budget on a monthly basis and all significant variances are investigated. There are defined authorisation procedures in respect of certain matters including capital expenditure, investments, the granting of guarantees and the use of financial instruments. The Audit Committee also receives, twice yearly, a review of all material litigation undertaken by, or against, the Group's companies and considers the associated risks.

The strength of an internal control system is dependent on the quality and integrity of management and staff. Those executives at senior levels are informed of their responsibilities as to the maintenance of sound systems of internal control. A routine and Group-wide process, which requires key executives and managers to certify their compliance with the Group's policies and procedures, reinforces this integrity.

The internal audit function operates as one Group-wide department which monitors and supports the internal control system and reports to both the Audit Committee and the Group's senior management. The responsibilities of the internal audit function include recommending improvements in the control environment and ensuring compliance with the Group's policies and procedures. The Audit Committee reviews the audit plan prepared by the Internal Audit Department.

An ongoing process for identifying, evaluating and managing the significant risks faced by the Group has been in place for the year under review and up to the date of this Report. This process is regularly reviewed by the Audit Committee on behalf of the Board and accords with the requirements of Internal Control: Guidance for Directors on the Combined Code.

During the year to 31 March 2005, significant potential risks facing the Group have been assessed and graded in a process managed by the Group Risk Director and involving line and functional management throughout the Group. The controls in place to manage or mitigate each risk were reviewed for adequacy and the processes to monitor and inform the Board about control performance were confirmed.

This assessment is overseen and supervised by the Group Risk Management Steering Committee. This Committee is chaired by the Chief Financial Officer and its members include representatives of the two operating businesses as well as the heads of relevant central functions. The assessment is reviewed by the Audit Committee and is repeated annually. The risk and control assessment is also shared with senior management throughout the Group.

The Board is aware of the disclosure guidelines on social responsibility issued by the Association of British Insurers, and an update on social, ethical and environmental ('SEE') issues is part of the Board's annual programme. Annual performance in these areas is already monitored and publicly disclosed through the Group's Social Responsibility reporting programme. As part of the annual risk review process and the presentation of those results to the Board, account is taken of any issues arising from SEE matters that could cause risk to value; no significant risks of this nature were identified during the year under review. The visibility of SEE matters in the risk-capture process has also been enhanced during the year under review. Appropriate SEE matters are included in the induction programme for Non-executive Directors.

The Group has in place a social responsibility policy as well as specific ethics and environmental policies. A revised ethics policy (Standards of Business Conduct) was issued in 2004. Compliance with the policy is monitored by means of self-certification by senior and middle management and through checks made by the Internal Audit Department. A Social Responsibility Report is published in respect of each financial year and a briefer review of such matters is included in this Annual Report on pages 38 to 42.

The Audit Committee receives additional assurance on the operation of internal control systems around the Group, primarily from the Internal Audit Department, which presents the conclusions of its reviews twice a year. The external auditor also takes internal financial control into consideration as part of its audit. In addition, incidences of control failure and the internal control implications of significant business issues are recorded in a central Control Issues Register, from which a summary report is prepared for the Audit Committee. A report is also prepared for distribution to senior management throughout the Group and appropriate actions are taken to rectify any control failures. Any significant new issues and material changes to the risk environment are reported at the next Board meeting.

Investor relations

The Group is committed to regular and open dialogue with investors. The Chairman and Executive Directors have held, and will continue to hold, discussions with institutional shareholders and analysts. The senior independent Non-executive Director is also available to meet investors, if so requested. In addition, there are general presentations to investors and analysts after the announcement of the half-year and annual results which are simultaneously webcast. From time to time, more tailored presentations on specific areas of importance are made.

Individual shareholders have the opportunity to question the Chairman and other Directors at the AGM and can meet them informally after the AGM. Results announcements and other press releases are made available on the Group's website as soon as possible after their publication.

Actions taken to develop an understanding amongst Directors of the views of major shareholders about the Group include reports to the Board on investor relations. Twice each year, these reports are supplemented by more detailed reviews by the Senior Vice President, Investor Relations, supported by the Company's brokers.

Remuneration report

for the year ended 31 March 2005

Remuneration Committee
The Board has delegated to the Remuneration Committee the approval of the remuneration and employment terms of the Executive Directors and certain other senior executives.

The Committee comprises the Non-executive Directors, all of whom are considered to be independent, and its membership during the year was as follows:

Committee Chairman
John Gildersleeve - *Non-executive Deputy Chairman* and *senior independent Non-executive Director.*

Committee Members
Sly Bailey - *Non-executive Director*
(since her appointment on 2 April 2004).
Harald Einsmann - *Non-executive Director*
(until his retirement on 13 July 2004).
Peter Georgescu - *Non-executive Director*
David Londoner - *Non-executive Director*
Kathleen O'Donovan - *Non-executive Director*

Terms of reference
The key terms of reference of the Committee are as follows:

- to provide the policy framework for the remuneration of Executive Directors, the Company Secretary and other senior executive and operational management (currently approximately 100 individuals in total);
- subject to the policy framework and the Code, to review in detail and approve all aspects of the terms and conditions of employment of each Executive Director and the Company Secretary, including their incentive arrangements, pension rights and any compensation payments;
- to review and approve the base salaries of the most senior direct-line reports to the Executive Directors, together with their remuneration packages, incentive arrangements, pension rights and any compensation payments;
- to determine targets for any performance-related incentive arrangements operated by the Company;
- to ensure the effective administration of any other long-term or share-based remuneration arrangements for employees;
- to ensure that regulations and codes on the disclosure of remuneration are adhered to by the Group; and,
- to review major changes in Group employee benefit structures.

The Committee is also authorised, where necessary, to obtain external independent professional advice.

The full terms of reference of the Committee can be obtained on request from the Company Secretary and are set out on the Company's website at www.emigroup.com.

Attendance at meetings and advisers
During the year, the Committee continued to use New Bridge Street Consultants LLP which it appointed as its adviser. This firm has provided material advice to the Committee to assist it in developing and monitoring policies for remunerating senior employees throughout the Group. The major areas for advice were Executive Directors' remuneration, determining competitive levels and forms of pay for Executive Directors and senior executives, reviewing incentive arrangements for that group, reviewing all share-based and long-term incentive plans and advising the Committee of developments and best practices for remuneration and applicable corporate governance requirements. New Bridge Street Consultants LLP has not, during the year, provided any other services to the Group. The letter of appointment in respect of New Bridge Street Consultants LLP can be viewed on the Group's website, www.emigroup.com, or obtained on request from the Company Secretary.

The Committee schedules three meetings during each year but also holds additional meetings as and when material matters arise for discussion. During the last financial year, the Committee met on six occasions.

Only Committee members are entitled to attend meetings of the Committee as of right, although the Executive Chairman (the 'Chairman'), the Human Resources executive charged with supporting the Committee (Carol Separovich as Vice President, Rewards Management) together with the Company Secretary & Group General Counsel (in his capacity as Committee Secretary) are generally invited to attend so as to assist and advise the Committee on matters under consideration. Other executives may be invited to attend in respect of specific issues where their guidance may be of assistance to the Committee. In this regard, during the last financial year the Chairman & Chief Executive Officer of EMI Music ('CEO EMI Music') and the Vice Chairman, EMI Music attended two meetings and one meeting, respectively, to provide material assistance and advice with regard to their division. None of these attendees participated in any discussion relating to his or her own remuneration.

In monitoring the level and mix of remuneration packages, the Committee has access to a number of music and general industry remuneration surveys, covering both local and international data. The Committee takes into account factors such as the nature, size, complexity and international profile of the surveyed companies relative to EMI; it also seeks such specific advice from external consultants as it considers appropriate.

Policy statement on Directors' remuneration

Background
The Committee recognises that, as a major UK-listed company, EMI should comply with the highest standards of corporate governance and, wherever it is appropriate to do so having regard to the wider interests of shareholders, UK remuneration best practices. Accordingly, the Committee periodically reviews the Group's remuneration practices against such standards and practices while recognising that the achievement of success in the highly competitive worldwide music market depends critically upon the Group's ability to compete for the management talent necessary to secure, develop and promote successful recording artists, composers and songwriters. The Group's remuneration policies, therefore, will continue to reflect the need to attract, retain and motivate top-calibre international management in the context of remuneration levels and practices in the international music and entertainment industry, many of which are set in the US, the indigenous repertoire of which, in the year ended 31 March 2005, amounted to 46.7% of worldwide record sales.

The Group's remuneration policies also recognise that the music publishing and recorded music businesses operate in distinct market places. The level and form of remuneration will continue to be tailored to the different market places in which the Group competes and to recognise the importance of creative talent to the overall success of the Group.

The remuneration packages of the Executive Directors have been designed to help them attain, and encourage them to retain, long-term interests in EMI's shares, and thereby align their interests with those of shareholders. Performance-related elements, in the form of annual bonuses and share-based long-term incentives, represent a significant proportion of the total annual remuneration opportunity, typically providing at least two-thirds of potential remuneration for the achievement of stretching performance targets.

Overview
The Group revised certain aspects of its remuneration policies during 2003. Notably, the introduction of the Executive Share Incentive Plan ('ESIP') was approved by shareholders at the 2003 Annual General Meeting. Revisions were also made to certain Executive Directors' service contracts to bring them into line with developments in best practice. The Committee considers it appropriate to apply the same policies in 2005 and, therefore, has made no changes to the general policy reported in the Annual Reports for the last two years.

Remuneration arrangements for Alain Levy
As reported last year, following consultation with major shareholders, the service contract of Alain Levy, CEO EMI Music, was amended as from 1 April 2004. The revised arrangements were designed to secure Mr Levy's services for EMI until at least March 2009 and are as follows:

- base salary was increased to £1.0m pa;
- the annual bonus opportunity was increased from two times salary to three times salary, by adding to the operating margin criterion a further potential one times salary opportunity by reference to turnover performance relative to the recorded music market (with nothing payable for below-market levels of turnover performance and increasing on a sliding scale); and,
- as originally contemplated when the ESIP was introduced, Mr Levy will not receive any share awards under that scheme until May 2006. It is envisaged that he will then participate on a comparable basis to other Executive Directors, with any awards being on the same basis (in terms of performance criteria, etc) but with awards based on a higher multiple of salary. It is currently intended that Mr Levy would receive annual grants of options over shares worth three times base salary and awards of performance shares worth one and a half times salary each year compared with, currently, two times salary and one times salary, respectively, for the Chairman and for the CFO.

The amended contract also contains two other changes from the previous agreement, namely, the enhancement of severance following a change of control (from 12 to 24 months) has been removed and, should Mr Levy wish to resign, the notice required from him has been increased from six to 12 months.

The Board and the Committee remain committed to a high proportion of the total earning opportunity being performance-dependent and only paying bonuses where stretching performance criteria have been satisfied.

Remuneration arrangements for Martin Stewart
Martin Stewart joined EMI on 5 January 2005 and became a Director on 1 February 2005 when he took up the appointment of CFO. In order to secure his appointment, the Committee agreed to the provision of a base salary of £525,000 pa. The first review of this salary will take effect from 1 July 2006.

For the period from 5 January to 31 March 2005, Mr Stewart was eligible for a discretionary pro-rata bonus, based on the rules of the Company's Executive Incentive Plan ('EIP'). Commencing from 1 April 2005, Mr Stewart will participate in the EIP, with his maximum annual bonus entitlement being 100% of his eligible base salary but with no entitlement to any guaranteed level of bonus.

On commencement of his employment, Mr Stewart received the following awards under the rules of the ESIP in respect of the period to 31 March 2006:

- an initial option grant over 519,116 shares with an exercise price of 252.833p per share; and,
- an initial performance share award over 259,558 shares.

Annual grants and awards will be made to Mr Stewart in accordance with the rules of the ESIP in each subsequent year starting with 2006, for which there will be no guaranteed awards. Such grants and awards will be made in accordance with the Committee's policy at the relevant grant date.

Extended contract and revised remuneration arrangements for Martin Bandier
The employment agreement of Martin Bandier, CEO EMI Music Publishing, was extended and revised as of 1 February 2005. The revised arrangements are designed to secure Mr Bandier's services as full-time Chairman of EMI Music Publishing until 31 March 2008, as well as securing an orderly succession plan for that business. From 1 April 2006 to 31 March 2007, Mr Bandier will become joint Chief Executive Officer of EMI Music Publishing with Roger Faxon. As of 1 April 2007, Mr Bandier will cease to be joint Chief Executive Officer but will remain as full-time Chairman until 31 March 2008. Thereafter, Mr Bandier will act as a consultant to EMI Music Publishing for a further three years.

Mr Bandier will cease to be a Director of the Company on 31 March 2006. Until his retirement as a Director, Mr Bandier's base salary will continue at its current level of US$3,331,635 pa and his annual performance bonus at target and maximum performance will continue to be 50% and 80% of base salary, respectively. The one-off long-term incentive arrangements for Mr Bandier, referred to in previous annual reports and set out in the tables accompanying this report, will continue in place for the period to 31 March 2006. From 1 April 2006, when Mr Bandier becomes joint Chief Executive Officer with Roger Faxon, his base salary will reduce to US$1,800,000 and his annual performance bonus at maximum performance will increase from 80% to 100% of base salary.

The Committee believes that these changes, which are designed to secure an orderly succession to the leadership of EMI Music Publishing, as well as the benefit of Mr Bandier's continued advice and assistance to the business thereafter, are appropriate.

Remuneration report

continued

Base salary
The Group believes pay should be closely linked to performance.

Base salary levels are determined by the Committee having regard to the experience and performance of the individual executive, the performance of the Group as a whole over the preceding year, data regarding external salary levels for comparable positions, internal relativities and wage inflation elsewhere in the Group. The Committee seeks to ensure that, in respect of industry-specific roles, base salaries are generally set no higher than the median for the music industry and, in the case of non-operational roles, has appropriate regard to general industry data.

Recognising the requirements of good corporate governance and a desire to constrain fixed costs to the advantage of all shareholders, base salaries for certain operating executives, most notably (and even after the revisions to his arrangements) for the CEO EMI Music, have been kept below industry market levels. In these instances, in order to deliver competitive overall levels of pay, the balance of the overall remuneration is weighted more significantly towards long-term incentives than is the case with EMI's major competitors.

The base salaries of each Executive Director on 31 March 2005 were as follows:

[illegible]	£721,500 pa
[illegible] Bandier	US$3,191,220 pa
[illegible] Levy	£1,000,000 pa
[illegible] Stewart	£525,000 pa

[illegible] are revised annually with any increases generally taking effect [illegible] for Mr Levy and Mr Bandier, and 1 July for Mr Nicoli and [illegible] later than Mr Levy and Mr Stewart, the Executive Directors [illegible] increase in the range of 3% to 4.5% in 2004 which was [illegible] the overall increase for other executives and staff. [illegible] first review will take effect from 1 July 2006.

[illegible]
[illegible] opportunities for Executive Directors remain at the same [illegible] year. For the Chairman and the CFO, the maximum bonus [illegible] 100% of base salary, whilst that for the CEO EMI Music is [illegible] base salary. In the case of the CEO EMI Music Publishing, the [illegible] bonus opportunity remains at 80% of base salary, with 50% [illegible] target performance. These bonus opportunities are paid in cash [illegible] approval of the accounts for the relevant year.

[illegible] criteria are tailored to individual positions and to ensure [illegible] are appropriate in all the circumstances. Subject to the [illegible] discretion and within the limits described above, bonuses [illegible] as follows:

[illegible] man and the CFO, two thirds of the bonus opportunity [illegible] reference to the attainment of stretching financial targets, [illegible] between pre-set profit and cashflow targets for the Group, [illegible] one third being determined by reference to [illegible] objectives set on a 'balanced-scorecard' basis;

[illegible] bonus for the CEO EMI Music Publishing is based on pre-set [illegible] relating to the division's economic profit (ie taking into account [illegible] the investment in the business) from year to year, reflecting [illegible] Publishing's objective of achieving sustained profit growth [illegible] providing an adequate return on invested assets; and,

[illegible] 2004, the annual bonus for the CEO EMI Music has been [illegible] that two thirds of his opportunity is measured by reference [illegible] operating profit margins, with the other third determined by [illegible] sales performance relative to the recorded music market.

The Committee's policy is not to pay transaction-related bonuses. Details of the bonuses achieved during the year by individual Executive Directors are set out on page 60.

Long-term incentive arrangements
Of the Executive Directors, the Chairman and the CFO currently participate in the ESIP. It is anticipated that both the CEO EMI Music and Martin Bandier, as the then joint CEO EMI Music Publishing, will participate in the ESIP as from 1 April 2006.

Under the terms of the ESIP, regular annual awards of both share options and performance shares are made, with awards vesting after a fixed three-year period subject to the achievement of demanding pre-vesting performance conditions.

The Committee determined that, for the first award made under the ESIP in 2003, options over shares worth two times base salary should be awarded, together with an award of performance shares worth one times base salary. This policy was implemented by the Committee throughout the last financial year and the Committee intends to continue to apply it in the current financial year. However, the mix of options and performance shares remains under review and may vary from year to year.

One third of the number of share options granted may be exercised if adjusted (ie normalised) earnings per share ('EPS') growth, over the three years following grant (with no retesting opportunities), exceeds an average of the increase in the Retail Prices Index ('RPI') plus 3% pa; two thirds of the number of share options granted may be exercised if normalised EPS growth exceeds an average of RPI plus 5% pa; and all share options granted may be exercised if normalised EPS growth exceeds an average of RPI plus 7% pa (with straight-line interpolation between the points). To the extent that the targets have not been fully satisfied, options will lapse.

Performance share awards vest by reference to the Company's relative Total Shareholder Return ('TSR') performance over a fixed three-year period (with no retesting opportunities). TSR is a measure of the return to a shareholder (in terms of share price appreciation, assuming reinvestment of any dividends) over a fixed period. 25% of the shares subject to an award will vest if the Company's TSR, relative to the companies in the FTSE Mid-250 Index (excluding investment trusts) as at the date of award, is at least at the median of that group. This will increase, on a straight-line basis, to full vesting if the Company's TSR is at least at the upper quintile (ie within the highest 20%) of that group. The share price used for calculating both the opening and closing TSR of the Company and each company in the comparator group for the three-year period will be assessed using three-month average figures. In addition to satisfying the TSR performance condition, awards will only vest to the extent that the Committee considers that the Company's TSR performance reflects the underlying performance of the Company over the period.

The EPS and TSR targets, which were selected following extensive discussions with the Company's leading institutional shareholders and which received the support of an overwhelming majority of those shareholders, are considered to be both demanding and stretching over the medium term in light of the prevailing business climate.

The EPS growth targets were chosen because profit growth (as measured through EPS) is currently a key objective within the Group and is considered to be the most appropriate measure of financial performance.

The FTSE Mid-250 Index was chosen as the TSR comparator group as there have been no, or insufficient, similarly sized independently quoted music companies to provide a more bespoke comparator group and, therefore, it was felt appropriate to compare the performance of EMI with the constituents of the FTSE Mid-250 Index on the basis that, from an investor perspective, shareholders have the choice of investing in EMI as compared with other UK-quoted companies of a similar size. If the Company becomes a constituent of the FTSE 100, the constituents of that Index would be used for subsequent grants.

In all the circumstances, the Committee considers these two measures, taken together, to be the most appropriate method of assessing the success of EMI over the medium term and, accordingly, considers them to be appropriate performance conditions. The Committee reviews these targets each year, prior to awards being made, to determine whether they remain appropriate.

The EPS measure is fully diluted EPS adjusted to take account of exceptional items and excluding amortisation. EMI's performance against the EPS and TSR targets will be monitored by the Committee, which will assess the extent to which the targets have been achieved. The EPS calculations will be verified by the Company's external auditor while the TSR calculations will be undertaken by New Bridge Street Consultants LLP. The Committee is conscious that the basis for calculating EPS is changing in light of the move from UK GAAP to International Accounting Standards and will ensure that any EPS performance conditions are measured on a consistent basis and as originally intended.

The Committee also confirms that the Company has at all times complied with the share dilution limits as previously agreed with shareholders.

As reported in previous years, the CEO EMI Music Publishing and the CEO EMI Music had one-off long-term incentive arrangements covering, in Mr Bandier's case, the period from April 2001 to 31 March 2006 and, in Mr Levy's case, the period from October 2001 to 31 March 2006. These arrangements are summarised in footnotes (b), (c) and (d) on page 63 and footnote (e) on page 64, respectively. Neither Mr Bandier nor Mr Levy will participate in the ESIP for the duration of these one-off arrangements. As part of the amendments to their service agreements, both Mr Levy and Mr Bandier will participate in the ESIP from 1 April 2006.

All UK-based Executive Directors are entitled to participate in the Group-wide ShareSave scheme on the same terms as other UK-based Group employees. Shareholder consent was obtained at the 2004 AGM for the renewal of the ShareSave scheme and also to introduce another tax-sponsored all-employee plan, the Share Incentive Plan ('SIP'). The operation of these plans will be at the discretion of the Committee, although Executive Directors will be eligible to participate on the same basis as other staff. No grants under the SIP were made during the year.

Details of the awards granted to Executive Directors under the ESIP and the ShareSave scheme are contained in the section on Current long-term incentive schemes on page 62. Details of share options and other share awards granted in previous years in accordance with the schemes then applying and the performance criteria attaching to those grants are contained in the section on Closed long-term incentive schemes on pages 63 and 64.

Benefits in kind

Benefits and perquisites are based on general industry practice and typically include a car or car allowance together with life assurance, retirement, disability and healthcare plans. Further details are set out on page 60.

Pension arrangements

For UK-based Executive Directors, the policy is to provide pension benefits through a 'final salary' arrangement with an accrual rate of 1/30th. Where possible, this is achieved through the Group's Inland Revenue-approved occupational pension scheme. Except in the case of the CFO, an unapproved defined contribution scheme is utilised to provide benefits on salaries above the Inland Revenue-imposed earnings cap, with the level of contribution being set by reference to an actuarial assessment of the value of a 1/30th arrangement. Benefits are based on base salaries only and specifically exclude bonuses. For the CFO, a pension allowance is provided, initially at the rate of 40% of annual earnings above the earnings cap but increasing by 1% per year until it reaches 50% of annual earnings above the cap.

For the US-based CEO EMI Music Publishing, the Group's retirement plan contributions are made with respect to both salary and annual bonus, consistent with normal practice in the US and the Group's benefit arrangements for all US employees.

The Committee is currently reviewing the impact of the changes to the tax treatment of UK pensions due to take effect in April 2006. It is not envisaged that the Company will meet any additional tax liabilities of executives and the review should, therefore, not result in an increase in overall cost to the Company.

Directors' service contracts
The Code recommends that notice or contract periods should be set at one year or less. It is the Group's policy to achieve that, where possible.

The Committee endorses the principle of mitigation of loss on early termination of a service contract and recognises the advantage of service contracts including an explicit calculation, subject to mitigation, of compensation payable upon early termination, other than for misconduct or in other circumstances justifying summary termination. The Committee's policy is that such compensation should generally be calculated by reference to base salary, annual bonus at target level and other benefits, including pension contributions, for the notice period or unexpired term of the service contract. The contract should also include an explicit obligation to mitigate and to offset earnings from alternative employment undertaken during the notice period or unexpired term of the contract against all or part of the compensation payment.

However, the Committee is conscious that fixed-term contracts of three or more years are common for senior executives in the global entertainment industry and such agreements often include no (or only a limited) obligation to mitigate. The Committee, therefore, considers that it is in the best interests of EMI and its shareholders to retain the flexibility to compete for top executive talent, where necessary, through the ability to offer contract terms in excess of one year. However, as an alternative, the Committee may agree compensation payments calculated without mitigation in order to limit contract terms or notice periods to one year.

Chairman and CFO - Eric Nicoli and Martin Stewart
The service contracts of Mr Nicoli and Mr Stewart, dated 11 April 2003 and 5 January 2005, respectively, are terminable by the Company on one year's notice.

In the case of gross misconduct or other circumstances justifying summary dismissal, the Company may terminate their service contracts without payment of compensation. Termination by the Company in other circumstances, without the required notice being given, entitles the departing executive to compensation, calculated on:

- his then base annual salary (currently £721,500 pa for Mr Nicoli and £525,000 pa for Mr Stewart) for one year; plus,
- the value of retirement benefits and either the continued enjoyment of, or the value of, benefits in kind provided to him for one year (the accrued value of such retirement contributions and the benefits in kind would have been £408,298 for Mr Nicoli and approximately £218,004 on an annualised basis for Mr Stewart had either one of them been dismissed on 31 March 2005); plus,
- a sum in respect of his lost annual bonus opportunity, being 50% of his maximum bonus for the period from the date of his departure to the end of the contractual notice period.

Their entitlement to such compensation is subject to both a duty to mitigate and, also, offset for any earnings which they derive from other employment during the unworked part of the notice period for which they have been compensated.

CEO EMI Music - Alain Levy
Mr Levy's service contract, which commenced on 15 October 2001 and was amended as of 1 April 2004, allows the Company to terminate his employment at any time without notice. If termination is for cause (as defined in the contract), no compensation is payable. If termination is without cause, or Mr Levy terminates the agreement for good reason (for example, breach by EMI), he is entitled to a lump-sum severance payment based on one year's pay, calculated using:

- his then base annual salary (currently £1,032,000 pa); plus,
- the value of retirement benefits and either the continued enjoyment of, or the value of, benefits in kind provided to him (the accrued value of such retirement contributions and the benefits in kind would have been £529,661 had he been dismissed on 31 March 2005); plus,
- the average annual bonus earned by him over the last three financial years (£730,474 in respect of years ended on or before 31 March 2005).

Mr Levy accepted a basic contract term of one year, which is significantly less than competitive music industry practice, as well as a base salary and potential cash bonus at levels lower than those for equivalent positions in other major record companies. In recognition of this, there is no obligation on Mr Levy to mitigate or to offset against the compensation payment any earnings from alternative employment following termination.

CEO EMI Music Publishing - Martin Bandier
Mr Bandier's employment agreement, dated as of 1 February 2005, is with a Group subsidiary in the US and is governed by New York state law. This agreement extends Mr Bandier's employment beyond 31 March 2006, which was the term date for the prior employment agreement between the same parties dated as of 1 April 2001. However, Mr Bandier will cease to be a Director of the Company on 31 March 2006. The contract allows the employing company to terminate his employment at any time without notice. If termination is for cause, no compensation is payable. If termination is without cause, or Mr Bandier terminates the contract for good reason, he is entitled to compensation based on two years' salary and benefits. The Committee considers that these terms for Mr Bandier are appropriate in view of competitive practice in the US, where he is resident and where EMI Music Publishing is headquartered, and the fact that the service contract is intended to secure his services until age 69. Additionally, following a change of control of the Company, Mr Bandier is entitled to terminate his service contract after a one-year transitional period and to receive a compensation payment as described below.

Where compensation is payable in respect of termination of Mr Bandier's service contract, it is specified to be the aggregate of:

- his then base annual salary (currently US$3,331,635 but reducing to US$1,800,000 as of 1 April 2006) for the succeeding two years; plus,
- continuation for two years of medical and dental benefits and retirement plan contributions (the accrued value of such retirement contributions and medical and dental benefits for the year ended 31 March 2005 would have been US$1,982,551 if his employment had been terminated on that date); plus,
- a sum in respect of lost annual bonus opportunity namely, 50% of annual base salary for each of the succeeding two years.

While, reflecting competitive music industry practice, there is no obligation on Mr Bandier to mitigate, the continuation of salary and bonus for 12 months after termination is subject to offset in respect of salary and bonus earned by Mr Bandier from a subsequent employer in the 12 months following termination; and the continuation of benefits is also offset to the extent of similar benefits provided by the subsequent employer.

Roger Faxon
Roger Faxon ceased to be a Director on 31 January 2005 but continues to be employed by EMI Music Publishing.

Mr Faxon's service agreement, dated as of 1 April 2003, allowed EMI to terminate the contract at any time without notice with a specified severance payment calculated on the same basis as if he were entitled to one year's notice. In the case of gross misconduct or other circumstances justifying summary dismissal, the Company could terminate his service contract without payment of compensation. Termination by the Company in other circumstances, without the required notice being given, entitled him to lump-sum compensation, calculated on:

- his then base annual salary (US$812,500 pa) for one year; plus,
- the value of retirement benefits and either the continued enjoyment of, or the value of, benefits in kind provided to him for one year (the accrued value of such retirement contributions and the benefits in kind would have been US$407,839 had he been dismissed on 31 January 2005); plus,
- a sum in respect of lost annual bonus opportunity, being 50% of his maximum bonus for the period from the commencement of the financial year in which he departed to the end of the contractual notice period.

In the light of competitive music industry practice, and in recognition of Mr Faxon's agreement, when he was promoted to CFO, to reduce his basic contract term from two years to one year, there was no obligation on him to mitigate, or to offset against the compensation payment any earnings from alternative employment during the year following termination. However, the Company's obligation to continue to provide insurance benefits would cease to the extent that similar benefits were provided by another employer following termination.

As Mr Faxon remained employed within the Group, on his ceasing to be a Director, no amount was paid to him by way of compensation for loss of office or under the provisions of his service contract as set out above.

Non-executive Directors
Non-executive Directors do not participate in the Group's bonus scheme or long-term incentive plans and are not eligible for membership of any of the Group's pension plans. Their fees are payable wholly in cash.

In view of the greater responsibilities of Non-executive Directors under the Combined Code together with their strategic contribution and increased time commitment, annual fees of £50,000 per annum have been paid since 1 January 2004. These fees will be reviewed every two years with the next review date being due on 1 January 2006. John Gildersleeve, the Deputy Chairman and senior independent Non-executive Director, receives an additional £40,000 per annum, reflecting his larger role and his chairmanship of the Remuneration and Nomination Committees. Kathleen O'Donovan receives an additional £10,000 per annum for chairing the Audit Committee. No other additional fees are payable for membership of Committees or otherwise.

The Non-executive Directors have letters of appointment from the Company which are available for inspection at the Company's registered office or on request and are also provided on the Company's website at www.emigroup.com. Each Non-executive Director is appointed for a specified term of an initial period to the next AGM after appointment and, subject to election at that Meeting, for a further period ending at the third AGM held thereafter. Subsequent reappointment is subject to endorsement by the Board and to re-election by the shareholders. Each Non-executive Director's date of appointment as a Director and his or her most recent date of re-election at an AGM is shown below:

	Date of appointment as a Non-executive Director	Date of letter of appointment	Date of last election or re-election at AGM
J Gildersleeve	28.2.04	25.4.05	13.7.04
S Bailey	2.4.04	25.4.05	13.7.04
P A Georgescu	1.9.02	25.4.05	9.7.03
D J Londoner	13.5.03	25.4.05	9.7.03
K A O'Donovan	21.11.97	25.4.05	13.7.04

Their appointments may be terminated at any time or in the event that they are not elected or re-elected by shareholders in accordance with the Company's Articles of Association. On termination, a Non-executive Director is entitled to any accrued but unpaid Directors' fees, but not to any other compensation. The new Articles, if adopted, provide that a Director will retire, if so agreed, earlier than three years from the date of last reappointment and also, if agreed, will not stand for re-election. This will ensure that the Company can, where appropriate, reappoint Non-executive Directors for periods which reflect corporate governance guidelines and that there will be consistency between the terms of appointment and the relevant provisions of the Articles.

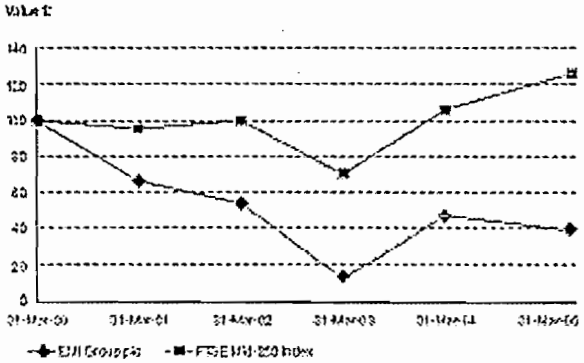
Remuneration report

continued

Total shareholder return performance graphs

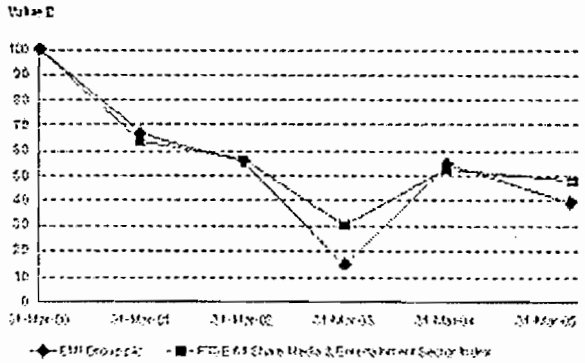
Under the Directors' Remuneration Report Regulations 2002, UK-listed companies are required to include a graph indicating their TSR (ie share price growth assuming reinvestment of any dividends) performance over the last five years relative to a recognised equity index. Consistent with the approach adopted last year, in the absence of suitable comparators, the Committee has again elected to show EMI's performance related to the FTSE Mid-250 Index. The FTSE Mid-250 Index (excluding investment trusts) was the comparator group for the TSR performance condition for last year's awards under the ESIP and will continue to be so for this and subsequent years unless the Company re-enters the FTSE 100.

Total shareholder return
Source: Thompson Financial



Additionally, this year the Committee is including the equivalent graph as against the FTSE All-Share Media & Entertainment Sector Index. This illustrates the volatility of the various indices particularly as, at the beginning of the five-year period, UK media stocks were at a relative peak as compared to other sectors.

Total shareholder return
Source: Thompson Financial



The graphs above look at the value, at the end of March 2005, of £100 invested in EMI Group plc on 31 March 2000 compared with the value of £100 invested in the FTSE Mid-250 and FTSE All-Share Media & Entertainment Sector Indices. The other points plotted in the graphs are the values at intervening financial year ends.

Policy on outside appointments

Executive Directors are permitted to take external appointments as non-executive directors but usually only one such appointment may be with another publicly quoted company. The remuneration from such appointments is retained by the Director and the table below sets out such amounts for the year ended 31 March 2005. All appointments must be approved by the Board to ensure that they do not give rise to any conflicts of interest.

	Name of Company	Fees received £
Executive Directors:		
E L Nicoli	The Tussauds Group Ltd	55,002
M N Bandier	National Music Publishers' Association	1,297
A M J I Levy	Schroder Venture Partners LLC	6,757
M D Stewart[a]	-	-
Former Executive Director:		
R C Faxon[b]	-	-

[a] Appointed as a Director on 1 February 2005.
[b] Resigned as a Director on 31 January 2005.

Share ownership guidelines

The Committee has adopted a formal policy that requires Executive Directors to hold shares in EMI worth at least two times their respective salaries. Executive Directors are required to build up this shareholding by retaining shares with a value of at least 25% of the after-tax gain arising on the maturity of any long-term incentive awards.

Pensions

The UK-based Executive Directors are executive members of the EMI Group Pension Fund which provides them, on normal retirement at age 60, with a pension of between 1/60th and 1/30th of the earnings cap for each year of membership, depending upon benefits built up prior to joining the Company. Members contribute 4% of the cap. On death, there is a spouse's pension of two thirds of the member's pension (ignoring the impact of any exchange of pension for a lump sum on retirement), plus child allowances if applicable. An early retirement pension may be paid on leaving but the pension is reduced by ⅓% for each month that pension starts earlier than age 60. Subject to the Company's (or, in the case of Executive Directors, the Committee's) consent, the reduction applied may be less.

ansfer values are calculated on a basis that assumes the pension would drawn at the earliest date where no reduction would apply and with lowance for future pension increases (both before and after pension ommences) to reflect the past practice of granting increases greater an those guaranteed.

ensions in payment are subject to annual increases at the lower of the crease in the RPI in the previous year and 5%. As all of the UK-based xecutive Directors joined the Company after 5 April 1997, there is no uaranteed Minimum Pension ('GMP') element included in their ensions. (The GMP is that part of the pension which replaces State arnings-Related Pension.)

he table below sets out the transfer value at 31 March 2005 of each xecutive Director's accrued deferred pension at that date as well as the ovement in that transfer value over the period. The transfer values are abilities of the EMI Group Pension Fund and reflect both the age of the xecutive Director and his length of service and membership of the Fund.

	Age at 31.3.05 Years	Accrued pension[a] at 31.3.05 £pa	Accrued pension[a] at 1.4.04 £pa	Increase in accrued pension during the year net of inflation[a] £pa	Transfer value of accrued pension[b] at 31.3.05 £	Transfer value of accrued pension[b] at 1.4.04 £	Directors' contributions during the year £	Increase in transfer value over the year net of Directors' contributions £pa
Executive Directors:								
E L Nicoli	54	10,058	8,112	1,695	160,783	122,117	4,080	34,586
A M J I Levy	58	5,808	3,987	1,697	115,851	74,275	4,080	37,496
M D Stewart[c]	41	567	–	–	4,059	–	680	3,379

[a] The accrued pensions are the amounts which would be paid if the Director left service at the relevant date.
[b] The transfer values have been calculated in accordance with guidance note GN11 published by the Institute of Actuaries and Faculty of Actuaries.
[c] Appointed as a Director on 1 February 2005.

The earnings cap (as defined in the Finance Act 1989) limits salary for pension purposes to £105,600 from 6 April 2005 (2004: £102,000). Therefore, as described above and except in the case of the CFO, the Company makes contributions to a separate defined contribution plan that provides additional benefits to those affected by the cap. The after-tax value of contributions, expressed as a percentage of base salary in excess of the cap, which the Company paid to the defined contribution plan in respect of Executive Directors, was:

E L Nicoli	33.42%
A M J I Levy	30.00%

The CFO receives a pension allowance, as described on page 55 and, therefore, does not participate in the defined contribution plan. This allowance amounted to £28,200 for the period from 1 February 2005 (the date he joined the Board) to 31 March 2005 and is included in 'Benefits' in the table on page 60.

Money purchase contributions in the year to 31 March 2005

	FURBS[a] £	Tax compensation £	Total £
Executive Directors:			
E L Nicoli	205,533	142,828	348,361
A M J I Levy	269,400	187,210	456,610
M D Stewart[b]	–	–	–

[a] Funded unapproved retirement benefits scheme.
[b] Appointed as a Director on 1 February 2005.

These contributions are set at levels which, based on actuarial advice, are likely to deliver comparable benefits to the capped final salary element.

The table below sets out the contributions made to US money purchase pension arrangements in respect of the two US-based Executive Directors who served during the year.

	Contributions by Group %	Contributions by Group US$	Contributions by Director %	Contributions by Director US$	Total US$
Executive Director:					
M N Bandier	33.4% of pay[a]	1,905,271	13% of pay[a]	741,572	2,646,843
Former Executive Director:					
R C Faxon[b]	50% of base salary	347,634	13.8% of base salary	95,947	443,581

[a] Consistent with US practice, pay for this purpose includes the value of annual cash bonuses.
[b] Resigned as a Director on 31 January 2005.

There were no retirement benefits paid to former Directors in excess of those to which they became entitled when such benefits first became payable to such former Directors.

Compensation to former Directors not previously reported
There were no compensation payments or other awards made to former Directors. As referred to above, Roger Faxon continues as an employee of EMI Music Publishing following his resignation as a Director and has received no compensation for loss of office.

Payments to third parties for making the Directors' services available
No payments have been made to third parties for making any Director's services available to the Company.

As required by the Directors' Remuneration Report Regulations, those items from the "Pensions" heading on page 58 to page 64 inclusive have been subject to audit.

By Order of the Board
John Gildersleeve
Deputy Chairman
20 May 2005

Remuneration report

continued

Remuneration details

Annual remuneration[a]

	Base salary or fees £'000	Compensation for loss of employment £'000	Expenses £'000	Benefits[b] £'000	Incentive[c] remuneration £'000	2005 Total in year £'000	2004 Total in year £'000
Executive Directors:							
E L Nicoli	716.2	–	–	46.6[d]	372.8	1,135.6	1,378.5
M N Bandier	1,725.0	–	–	41.8	1,379.9	3,146.7	3,318.4
A M J I Levy	1,000.0	–	–	53.7	997.0	2,050.7	1,595.8
M D Stewart (appointed 1.2.05)	87.5	–	–	32.6[e]	51.0	171.1	–
Non-executive Directors:							
J Gildersleeve	90.0	–	–	–	–	90.0	7.5
S Bailey (appointed 2.4.04)	49.9	–	–	–	–	49.9	–
P A Georgescu	50.0	–	–	–	–	50.0	35.3
D J Londoner	50.0	–	–	–	–	50.0	35.4
K A O'Donovan	60.0	–	–	–	–	60.0	46.5
Former Executive Director:							
R C Faxon (resigned 31.1.05)	375.8	–	–	286.3[f]	170.2	832.3	885.7
Former Non-executive Director:							
H Einsmann (retired 13.7.04)	14.2	–	–	–	–	14.2	39.5
Total 2005	4,218.6	–	–	461.0	2,970.9	7,650.5	–
Total 2004	3,899.6	–	–	222.9	3,280.1	–	7,402.6

[a] Excludes retirement contributions (see table on page 59) and the value of share awards ceasing to be contingent, as reported in the table shown below.

[b] The nature of the non-cash benefits provided to Executive Directors who held office during the year is as follows:

E L Nicoli: -provision of a Company car plus use of a Company pool car and driver until 28 February 2005 and, since 1 March 2005, a car allowance plus use of a Company pool car and driver;
-private healthcare; and,
-personal accident insurance.

M N Bandier: -a car allowance of US$36,000 pa; and,
-participation in the Group's US executive medical plan, life, health (hospital, major medical and dental) and accident insurance.

A M J I Levy: -use of a Company pool car and driver;
-private healthcare; and,
-personal accident insurance.

M D Stewart: -a car allowance plus use of a Company pool car and driver;
-private healthcare; and,
-personal accident insurance.

R C Faxon: -a car allowance of US$25,000 pa;
-participation in the Group's US executive medical plan, life, health (hospital, major medical and dental) and accident insurance; and,
-health club memberships in both New York and London.

[c] Bonuses paid to the Executive Directors reflect the factors referred to on page 54. Bonuses for Mr Nicoli and Mr Faxon reflect full achievement of the cashflow target and the Committee's assessment of their performance against strategic objectives. In Mr Stewart's case, the bonus is pro-rated for the part of the year during which he was a Director. In Mr Levy's case, EMI Music's operating profit margin was at approximately the mid-point of the scale set in his employment contract but the bonus element in respect of relative sales growth/decline did not result in a payment. The economic profit achieved by EMI Music Publishing resulted in Mr Bandier achieving his maximum bonus opportunity of 80% of base salary.

[d] The 2005 benefits figure for Mr Nicoli is significantly lower than that for the equivalent period in 2004 as the payment in respect of Mr Nicoli's private healthcare and personal accident insurance for 2005 was accounted for in the period ended 31 March 2004.

[e] For Martin Stewart, this includes the pension allowance which is more fully described on page 55 in the Remuneration Report.

[f] Includes tax equalisation payments totalling £253,775 paid in the year ended 31 March 2005 relating to service in the UK for the US tax periods from 1 January 2002 through to 31 January 2005 (when Mr Faxon ceased to be a Director). Of this amount, £146,663 is in respect of the 2002 and 2003 US tax years which coincide with the calendar years.

Remuneration from prior-year share awards ceasing to be contingent

	Awards No. of shares	2005 Total value[a] £'000	Awards No of shares	2004 Total value[a] £'000
Executive Directors:				
E L Nicoli	–	–	–	–
M N Bandier	165,625[b]	391.3	165,625[b]	459.6
A M J I Levy	–	–	–	–
M D Stewart (appointed 1.2.05)	–	–	–	–
Former Executive Director:				
R C Faxon (resigned 31.1.05)	298,250	704.6	–	–[c]
Total	463,875	1,095.9	165,625	459.6

[a] The value is based on the share price on the date awards ceased to be contingent.

[b] Whilst in certain circumstances these restricted share awards may lapse or be released before the vesting date, a proportion of their value is included in reported remuneration each year to match remuneration costs more accurately to the time period in which these shares are earned.

[c] In the report for the period to 31 March 2004, an award over 103,803 shares with a value of £288,100 was shown as ceasing to be contingent. Following the publication of the Company's preliminary results to 31 March 2004, Mr Faxon deferred the vesting of this award for a period of three years. Accordingly, the figures for the period to 31 March 2004 have been restated.

Directors' interests

Directors' interests (all beneficial) in the Company's Ordinary Shares of 14p each[abc]

	Non-contingent share awards[d]	Directly held shares	As at 31.3.05 total shares held[e]	As at 1.4.04 or date of appointment if later Total shares held
Executive Directors:				
E L Nicoli	133,982	69,426	203,408[e]	203,392
M N Bandier	–	379,760	379,760	379,760
A M J I Levy	–	775,000	775,000	775,000
M D Stewart (appointed 1.2.05)	–	–	–	–
Non-executive Directors:				
J Gildersleeve	–	1,377	1,377	1,254
S Bailey (appointed 2.4.04)	–	1,250	1,250	–
P A Georgescu	–	100,000	100,000	100,000
D J Londoner	–	10,000	10,000	10,000
K A O'Donovan	–	2,000	2,000	2,000

[a] The Company's Register of Directors' Interests is available for inspection in accordance with the provisions of the Companies Act 1985.

[b] No Director had any interest in either shares or debentures of any subsidiary of the Company.

[c] As potential beneficiaries under the EMI Group General Employee Benefit Trust ('EBT'), the Executive Directors are deemed to be interested in the entire shareholding of the EBT which at 31 March 2005 amounted to 3,840,515 shares.

[d] Non-contingent share awards shown in this column are also included as incentive awards in the table on page 63. Such awards, made under the now-closed Senior Executive Incentive Plan, arise from the deferral of annual cash bonuses into shares. The awards are subject to an additional 1:3 matching award if deferred for three years from the date of the award, or an additional 2:3 award if deferred for six years from the date of the award.

[e] Mr Nicoli's interest in shares declined by 2,205 shares on 9 May 2005 when the connected person beneficially owning such shares ceased to be a person connected to him. There has been no other change in these interests between 31 March 2005 and the date of this report.

Remuneration report

continued

Current long-term incentive schemes

Directors' outstanding performance share awards under the Executive Share Incentive Plan[a b]

	Date of award	Earliest normal vesting date	Lapse date	As at 1.4.04 or date of appointment if later	Vested in year	Awarded in year	Lapsed in year	As at 31.3.05 or date of resignation if earlier
Executive Directors:								
E L Nicoli	14.7.03	14.7.06	13.1.07	515,294	–	–	–	515,294
	18.6.04	18.6.07	17.12.07	–	–	313,153[c]	–	313,153
Total				**515,294**	**–**	**313,153**	**–**	**828,447**
M D Stewart[d]	7.1.05	7.1.08	6.7.08	259,558	–	–	–	259,558
Total				**259,558**	**–**	**–**	**–**	**259,558**
Former Executive Director:								
R C Faxon[e]	14.7.03	14.7.06	13.1.07	375,255	–	–	–	375,255
	18.6.04	18.6.07	17.12.07	–	–	207,510[c]	–	207,510
Total				**375,255**	**–**	**207,510**	**–**	**582,765**

[a] Exercise is subject to the performance target set out in the policy section of this report in respect of performance share awards, namely based on the Company's Total Shareholder Return ('TSR'), compared to FTSE Mid-250 companies excluding investment trusts, over a fixed three-year period.

[b] The rules of the ESIP currently provide that a participant is required to make payment of a nominal sum of £1 in aggregate on the exercise of a share award, unless such sum is waived by the Remuneration Committee. Since 31 March 2005, the Remuneration Committee has concluded that, so as to ease the administration of such awards if and when they vest, the payment of this nominal amount should be waived or removed.

[c] The closing mid-market share price on the date of the award was 234p.

[d] Appointed 1 February 2005.

[e] Resigned 31 January 2005.

Directors' outstanding share options over Ordinary Shares of 14p each under the Executive Share Incentive Plan[a]

	Date granted	Earliest normal exercise date	Lapse date	Exercise price	As at 1.4.04 or date of appointment if later	Exercised in year	Granted in year	Lapsed in year	As at 31.3.05 or date of resignation if earlier
Executive Directors:									
E L Nicoli	14.7.03	14.7.06	13.7.13	119.25p	1,030,589	–	–	–	1,030,589
	18.6.04	18.6.07	17.6.14	223.66p	–	–	626,307	–	626,307
Total					**1,030,589**	**–**	**626,307**	**–**	**1,656,896**
M D Stewart[b]	7.1.05	7.1.08	6.1.15	252.833p	519,116	–	–	–	519,116
Total					**519,116**	**–**	**–**	**–**	**519,116**
Former Executive Director:									
R C Faxon[c]	14.7.03	14.7.06	13.7.13	119.25p	750,511	–	–	–	750,511
	18.6.04	18.6.07	17.6.14	223.66p	–	–	415,020	–	415,020
Total					**750,511**	**–**	**415,020**	**–**	**1,165,531**

[a] Exercise is subject to the performance target set out in the policy section of this report in respect of grants of share options, namely the Company's Earnings Per Share ('EPS') growth over a fixed three-year period.

[b] Appointed 1 February 2005.

[c] Resigned 31 January 2005.

Directors' outstanding share options over Ordinary Shares of 14p each under the ShareSave scheme

	Date granted	Earliest normal exercise date	Lapse date	Exercise price	As at 1.4.04	Exercised in year	Granted in year	Lapsed in year	As at 31.3.05
Executive Directors:									
E L Nicoli	19.6.03	1.9.08	28.2.09	96p	16,588	–	–	–	16,588
Total					**16,588**	**–**	**–**	**–**	**16,588**
A M J I Levy	19.6.03	1.9.08	28.2.09	96p	16,588	–	–	–	16,588
Total					**16,588**	**–**	**–**	**–**	**16,588**

ShareSave options are normally exercisable for a six-month period following completion of savings to either a three-year or a five-year ShareSave contract and are not subject to additional performance conditions.

Closed long-term incentive schemes

Directors' outstanding share awards under long-term incentive plans

	Date of award	As at 1.4.04 Incentive[a]	Performance[b]	Restricted[c]	During year Matching awards	Vested	Lapsed	As at 31.3.05 or date of resignation if earlier
Executive Directors:								
E L Nicoli	31.5.00	67,722	–	–	–	–	–	67,722
	31.5.01	66,260	–	–	–	–	–	66,260
Total		**133,982**	**–**	**–**	**–**	**–**	**–**	**133,982**
M N Bandier	28.9.01	–	1,250,000[d]	–	–	–	–	1,250,000
	28.9.01	–	–	662,500[d]	–	–	–	662,500
Total		**–**	**1,250,000**	**662,500**	**–**	**–**	**–**	**1,912,500**
Former Executive Director:								
R C Faxon[e]	18.6.99	88,848	–	–	59,232	(148,080)[f]	–	–
	31.5.00	18,888	–	–	–	–	–	18,888
	31.5.01	56,300	–	–	–	–	–	56,300
	15.6.01	–	103,803	–	–	–	–	103,803
	28.5.02	112,628	–	–	37,542	(150,170)[g]	–	–
Total		**276,664**	**103,803**	**–**	**96,774**	**(298,250)**	**–**	**178,991**

[a] Incentive share awards are not contingent on future performance and/or are no longer subject to forfeiture. Such awards, made under the now-closed Senior Executive Incentive Plan, arise from the deferral of annual cash bonuses into shares. The awards are subject to an additional 1:3 matching award if deferred for three years from the date of the award, or an additional 2:3 award if deferred for six years from the date of the award.

[b] Shows total potential award.

- The total of the eventual award depends on the achievement of Group or business unit performance against profit targets set by the Remuneration Committee in respect of a performance period that terminates on 31 March in the third year after the date of the award. The eventual award is subject to an additional 1:3 matching award if vesting is deferred for a further three years from the vesting date. In certain circumstances, for example upon a change of control of EMI, awards could be released before the normal vesting date.
- Mr Faxon participated in a performance share award granted on 15 June 2001 based on EMI Music Publishing's performance, which required growth of between 6.1% and 22.5% in EMI Music Publishing's economic profit over three years. In the report for the period to 31 March 2004, this award over 103,803 shares was shown as ceasing to be contingent and was valued at £288,100. Following the publication of the Company's preliminary results to 31 March 2004, Mr Faxon deferred the vesting of this award for a period of three years. Accordingly, the figures in respect of this award have been restated.
- In 2001, in place of overlapping annual share awards based on three-year performance cycles, Mr Bandier was granted a one-time performance share award which requires 2% pa growth in the Music Publishing division's economic profit for the entire performance period to 31 March 2006, at which level one sixth of the shares accrue, with maximum payout at 7% pa growth (with straight-line vesting between these two points).

[c] Mr Bandier's restricted share award will vest no earlier than 31 March 2006. The award was in lieu of additional base salary and is not, therefore, subject to performance requirements. The aim of the award was to bring Mr Bandier's basic annual remuneration into line with competitive practice in the US, where he is based, whilst aligning his interests more closely with those of the shareholders and providing him with a strong incentive to remain with the Group. No further awards of this nature are envisaged. A proportion of this award is included in remuneration each year so as to match remuneration costs more accurately to the time period in which the shares are earned.

[d] With the exception of Mr Bandier's awards, on termination of employment in certain circumstances, for example, as a result of death, disability, sale of the relevant business unit, normal retirement, or termination without cause, and if the performance criteria are on target for achievement, a proportion of the awards may become exercisable prior to normal vesting. If the performance criteria are not on target for achievement, the whole award lapses if it has not reached its normal vesting date. Upon a change of control, all awards vest, or can be exchanged for an equivalent value of awards in the acquiring entity, with identical terms to the original awards.

Mr Bandier's outstanding share awards would vest, in whole or in part, if he was dismissed (other than for cause) or following a change of control of EMI. Both his performance share and restricted share awards will lapse if, prior to the vesting date of 31 March 2006, Mr Bandier resigns voluntarily or his employment agreement is terminated by EMI for cause. However, if Mr Bandier's employment is terminated without cause by EMI, he will receive the proportion of his restricted share award which he would have earned had he remained in employment for a further two years. Under these same circumstances, he would also receive a proportion of his performance share award pro-rated to the date of termination, subject to the achievement of the relevant performance criteria. In the event of a change of control of EMI, all the restricted share award would vest together with a proportion of the performance share award pro-rated to the date of the change of control together with an additional 625,000 shares up to the maximum award of 1.25m shares. Vesting would take place on the earlier of one year after the date of the change of control or the termination of his employment without cause.

[e] Resigned 31 January 2005.

[f] The closing mid-market share prices on the dates of the award (18 June 1999) and vesting (31 March 2005) were 528.75p and 236.25p, respectively.

[g] The closing mid-market share prices on the dates of the award (28 May 2002) and vesting (31 March 2005) were 267.25p and 236.25p, respectively.

Directors' outstanding share options over Ordinary Shares of 14p each[ab]

	Date granted	Earliest normal exercise date[cd]	Lapse date	Exercise price	As at 1.4.04	Exercised in year	Granted in year	Lapsed in year	As at 31.3.05 or date of resignation if earlier
Executive Directors:									
E L Nicoli	3.6.99	3.6.02	2.6.09	440.000p	60,000	–	–	–	60,000
	21.6.02	21.6.05	20.6.12	243.300p	838,471	–	–	–	838,471
Total					**898,471**	**–**	**–**	**–**	**898,471**
M N Bandier	25.8.95	25.8.98	24.8.05	590.315p	253,084	–	–	–	253,084
	23.8.96	23.8.99	22.8.06	734.500p	60,000	–	–	–	60,000
	6.6.97	6.6.00	5.6.07	575.000p	52,144	–	–	–	52,144
Total					**365,228**	**–**	**–**	**–**	**365,228**
A M J I Levy[e]	15.10.01	15.10.04	14.10.11	300.000p	3,000,000	–	–	–	3,000,000
	15.10.01	15.10.04	14.10.11	400.000p	3,000,000	–	–	–	3,000,000
	15.10.01	15.10.04	14.10.11	500.000p	2,000,000	–	–	–	2,000,000
	15.10.01	15.10.04	14.10.11	700.000p	2,000,000	–	–	–	2,000,000
	2.1.02	2.1.05	1.1.12	357.300p	2,000,000	–	–	–	2,000,000
	19.12.02	19.12.05	18.12.12	146.050p	2,000,000	–	–	–	2,000,000
	19.12.02	19.12.06	18.12.12	153.750p	2,000,000	–	–	–	2,000,000
	19.12.02	19.12.07	18.12.12	269.050p	2,000,000	–	–	–	2,000,000
	19.12.02[e]	19.12.08	18.12.12[e]	–	2,000,000	–	–	–	2,000,000
Total					**20,000,000**	**–**	**–**	**–**	**20,000,000**
Former Executive Director:									
R C Faxon[f]	23.8.96	23.8.99	22.8.06	734.500p	67,500	–	–	–	67,500
	6.6.97	6.6.00	5.6.07	575.000p	50,326	–	–	–	50,326
	5.2.02	5.2.05	4.2.12	305.000p	500,000	–	–	–	500,000
	28.5.02	28.5.05	27.5.12	267.250p	250,000	–	–	–	250,000
	21.6.02	21.6.05	20.6.12	244.000p	283,000	–	–	–	283,000
Total					**1,150,826**	**–**	**–**	**–**	**1,150,826**

[a] No Directors' share options were exercised in the year. Therefore, the total gain made on the exercise of share options was £nil (2004: £nil). The closing mid-market share price on 31 March 2005 was 236.25p. The range of closing mid-market share prices during the year was 191p and 281.25p.

[b] All of the options were granted for nil consideration.

[c] Executive Directors' share options are normally exercisable during the period commencing no earlier than three years and ending no later than 10 years from the date granted.

[d] Share options were granted to Executive Directors in previous years in accordance with the relevant Executive Share Option Scheme rules and market practice at the time. The table above sets out information on the current Executive Directors' grants of such share options. The performance criteria relating to these grants are as follows:

- For the period from 25 August 1995 to 9 December 1999, the criterion was that the Company's TSR over the relevant calculation period compared to the TSR of the companies in the FTSE 100 at 1 April prior to the date of grant is at least equal to the median of that group. TSR is the percentage growth of the share price, assuming reinvestment of any dividends paid, over the calculation period. The initial calculation period commences on 1 April immediately preceding the date of grant and ends on 31 March three years later and, thereafter, calculations are made at each quarter end for the preceding three-year period until the performance criterion is met or the option lapses.
- For the period from 10 December 1999 to 8 July 2003 (excluding Mr Levy's grants – see footnote (e) below), the criterion was that the increase in the Group's adjusted, fully diluted EPS over a three-year period following the date of grant should exceed an average of the UK retail prices index ('RPI') plus a rate ranging between 2% and 3% pa.

The Committee chose the relevant performance criteria as they were considered to be challenging and in accordance with the then existing market practice, while aligning Executive Directors' interests with those of shareholders.

[e] On appointment, Mr Levy was granted options over 10m shares at prices between 300p and 700p. Since appointment, Mr Levy has been granted additional options over a further 10m shares which represent his entitlement to options in respect of the five financial years up to and including, but ending on, 31 March 2006. The exercise prices for these options are determined after the announcement of the interim results for the respective financial years, using a five-day average share price. Exercise of all the options is generally conditional on the Company's adjusted diluted EPS growing by at least an average of RPI plus 2.5% pa over the period from 31 March 2002 to the 31 March following the relevant vesting date with retesting throughout the option's life. The terms of Mr Levy's contract prescribe the impact of a cessation of employment or a change of control of EMI on the share options granted under his contract. If Mr Levy's appointment were terminated by EMI without cause or by Mr Levy with good reason (as defined in the contract), the options over 10m shares granted on 15 October 2001 would vest and could be exercised without regard to the performance conditions.

If Mr Levy's appointment is terminated in the circumstances described in the preceding paragraph, the options granted on 2 January and 19 December 2002 for which the prices have been determined by the date of termination, as set out in the table above, will vest and may be exercised without regard to the performance conditions; all other options would lapse. The exercise of options vested under the preceding paragraph must be undertaken within 12 months of the date of termination. On a change of control of EMI, Mr Levy's options will be treated as if his employment had been terminated by EMI without cause with the result that they may be exercised without regard to performance conditions, but the exercise period will be limited to six months. A termination resulting from Mr Levy's death or disability will be treated in the same manner as a termination by the Company without cause.

[f] Resigned 31 January 2005.

Listen.

Over the last year listening to music stored on a computer rose 22 per cent and online radio listening increased 18 per cent.

Source: NPD

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Auditor's report

Independent Auditor's report to the members of EMI Group plc
We have audited the Group's financial statements for the year ended 31 March 2005 which comprise the Consolidated profit and loss account, Consolidated balance sheet, Company balance sheet, Consolidated cash flow statement, Statement of total recognised gains and losses, Reconciliation of movements in shareholders' funds and the related notes 1 to 28. These financial statements have been prepared on the basis of the accounting policies set out therein. We have also audited the information in the Directors' Remuneration report that is described as having been audited.

This report is made solely to the Company's members, as a body, in accordance with Section 235 of the Companies Act 1985. Our audit work has been undertaken so that we might state to the Company's members those matters we are required to state to them in an auditors' report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Company and the Company's members as a body, for our audit work, for this report, or for the opinions we have formed.

Respective responsibilities of Directors and Auditor
The Directors are responsible for preparing the Annual Report, including the financial statements which are required to be prepared in accordance with applicable United Kingdom law and accounting standards as set out in the Statement of Directors' Responsibilities in relation to the financial statements.

Our responsibility is to audit the financial statements and the part of the Directors' Remuneration report to be audited in accordance with relevant legal and regulatory requirements, United Kingdom Auditing Standards and the Listing Rules of the Financial Services Authority.

We report to you our opinion as to whether the financial statements give a true and fair view and whether the financial statements and the part of the Directors' Remuneration report to be audited have been properly prepared in accordance with the Companies Act 1985. We also report to you if, in our opinion, the Directors' report is not consistent with the financial statements, if the Company has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law or the Listing Rules regarding Directors' remuneration and transactions with the Group is not disclosed.

We review whether the Corporate governance statement reflects the Company's compliance with the seven provisions of the Combined Code specified for our review by the Listing Rules, and we report if it does not. We are not required to consider whether the Board's statements on internal control cover all risks and controls, or form an opinion on the effectiveness of the Group's corporate governance procedures or its risk and control procedures.

We read other information contained in the Annual Report and consider whether it is consistent with the audited financial statements. This other information comprises the Directors' report, unaudited part of the Directors' Remuneration report, Chairman's statement, Operating reviews, Financial review and Corporate governance statement. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements. Our responsibilities do not extend to any other information.

Basis of audit opinion
We conducted our audit in accordance with United Kingdom Auditing Standards issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements and the part of the Directors' Remuneration report to be audited. It also includes an assessment of the significant estimates and judgements made by the Directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the Group's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements and the part of the Directors' Remuneration report to be audited are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements and the part of the Directors' Remuneration report to be audited.

Opinion
In our opinion the financial statements give a true and fair view of the state of affairs of the Company and of the Group as at 31 March 2005 and of the profit of the Group for the year then ended; and the financial statements and the part of the Director's Remuneration report to be audited have been properly prepared in accordance with the Companies Act 1985.

Ernst & Young LLP
Registered Auditor
London
23 May 2005

Consolidated profit and loss account

for the year ended 31 March 2005

	Notes	Total £m
Group turnover	1	1,942.8
Group operating profit before exceptional items and amortisation	1	232.9
Operating exceptional items	8	–
Group operating profit before amortisation		232.9
Amortisation		(50.7)
Group operating profit*	1&2	182.2
Share of operating profits (losses) in associated undertakings	1	0.9
Total operating profit		183.1
Non-operating exceptional items	1&8	0.8
Profit before finance charges		183.9
Finance charges	1&5	(92.1)
Profit (loss) on ordinary activities before taxation	1	91.8
Taxation on profit (loss) on ordinary activities (including associated undertakings)	6	(31.2)
Profit (loss) on ordinary activities after taxation		60.6
Minority interests (equity)		(4.3)
Profit (loss) attributable to members of the Holding Company		56.3
Dividends (equity)	7	(63.2)
Transfer (from) to profit and loss reserve		(6.9)

* The following items are included within Group operating profit

Cost of sales	2	(1,225.3)
Gross profit		717.5
Distribution costs	2	(69.6)
Administration expenses	2	(504.0)
Other operating income, net	2	38.3

Earnings Per Ordinary Share (EPS)

		Year ended 31 March 2005
Basic earnings per Ordinary Share	9	7.2p
Diluted earnings per Ordinary Share	9	7.2p
Adjusted basic earnings per Ordinary Share	9	13.5p
Adjusted diluted earnings per Ordinary Share	9	13.0p

Adjusted earnings are included as they provide a better understanding of the underlying trading performance of the Group on a normalised basis.

Average exchange rates for the year

	Year ended 31 March 2005
US Dollar to £1	1.85
Euro to £1	1.46
Yen to £1	198.32

The results for the year have been translated into Sterling at the appropriate average exchange rates.

Year ended 31 March 2005				Year ended 31 March 2004
	EMI Group	EMI Group		Total
Exceptional items (Note 8) and amortisation £m	Before exceptional items and amortisation £m	Before exceptional items and amortisation £m	Exceptional items (Note 8) and amortisation £m	£m
–	1,942.8	2,120.7	–	2,120.7
–	232.9	249.3	–	249.3
–	–	–	(138.3)	(138.3)
–	232.9	249.3	(138.3)	111.0
(50.7)	–	–	(50.9)	(50.9)
(50.7)	232.9	249.3	(189.2)	60.1
(0.2)	1.1	(0.1)	(0.2)	(0.3)
(50.9)	234.0	249.2	(189.4)	59.8
0.8	–	–	(16.5)	(16.5)
(50.1)	234.0	249.2	(205.9)	43.3
–	(92.1)	(85.9)	(10.2)	(96.1)
(50.1)	141.9	163.3	(216.1)	(52.8)
–	(31.2)	(32.5)	12.8	(19.7)
(50.1)	110.7	130.8	(203.3)	(72.5)
–	(4.3)	(6.5)	7.4	0.9
(50.1)	106.4	124.3	(195.9)	(71.6)
				(62.5)
				(134.1)
(45.8)	(1,179.5)	(1,286.0)	(118.7)	(1,404.7)
(45.8)	763.3	834.7	(118.7)	716.0
–	(69.6)	(85.1)	(6.9)	(92.0)
(4.9)	(499.1)	(530.7)	(52.8)	(583.5)
–	38.3	30.4	(10.8)	19.6

Year ended 31 March 2004
(9.1)p
(9.1)p
15.8p
15.5p

Year ended 31 March 2004
1.70
1.45
191.67

Balance sheets

at 31 March 2005

	Notes	Group 2005 £m	Group 2004 £m	Company 2005 £m	Company 2004 £m
Fixed assets					
Music copyrights	10	402.8	448.7	–	–
Goodwill	11	33.2	31.8	–	–
Tangible fixed assets	12	183.1	202.7	23.3	31.7
Investments	13	22.9	19.3	2,225.9	2,211.7
		642.0	702.5	2,249.2	2,243.4
Current assets					
Stocks	14	28.2	28.1	–	–
Debtors: amounts falling due within one year	15	720.8	722.6	2,465.8	2,432.8
Debtors: amounts falling due after more than one year	15	79.5	88.3	–	0.4
Investments: liquid funds	16	1.6	1.8	–	–
Cash at bank and in hand and cash deposits	16	240.9	343.4	1.3	5.0
		1,071.0	1,184.2	2,467.1	2,438.2
Creditors: amounts falling due within one year					
Borrowings	16	(30.0)	(35.8)	–	–
Other creditors	18	(1,292.7)	(1,353.5)	(148.0)	(146.5)
		(1,322.7)	(1,389.3)	(148.0)	(146.5)
Net current (liabilities) assets		(251.7)	(205.1)	2,319.1	2,291.7
Total assets less current liabilities		390.3	497.4	4,568.3	4,535.1
Creditors: amounts falling due after more than one year					
Borrowings (including convertible debt)	16	(1,042.0)	(1,058.1)	(602.8)	(593.2)
Other creditors	19	(10.2)	(12.9)	(792.6)	(777.5)
		(1,052.2)	(1,071.0)	(1,395.4)	(1,370.7)
Provisions for liabilities and charges	20 & 21	(85.2)	(142.8)	(2.3)	(3.5)
		(747.1)	(716.4)	3,170.6	3,160.9
Capital and reserves					
Called-up share capital	22	110.6	110.4	110.6	110.4
Share premium account	22	447.3	445.8	447.3	445.8
Capital redemption reserve	23	495.8	495.8	495.8	495.8
Other reserves	23	252.2	255.7	400.8	402.1
Profit and loss reserve (including goodwill previously written off)	23	(2,101.3)	(2,091.7)	1,716.1	1,706.8
Equity shareholders' funds		(795.4)	(784.0)	3,170.6	3,160.9
Minority interests (equity)	24	48.3	67.6	–	–
		(747.1)	(716.4)	3,170.6	3,160.9

Year-end exchange rates

	2005	2004
US Dollar to £1	1.89	1.84
Euro to £1	1.45	1.50
Yen to £1	202.11	191.20

The balance sheet has been translated into Sterling at the appropriate year-end exchange rates.

Eric Nicoli
Martin Stewart
Directors
23 May 2005

Statement of total recognised gains and losses

for the year ended 31 March 2005

	£m	2005 £m	£m	2004 £m
Profit (loss) for the financial year				
Group		55.4		(71.3)
Associated undertakings		0.9		(0.3)
Profit (loss) for the financial year		56.3		(71.6)
Currency translation – Group*	(7.2)		28.0	
Impairment of revalued property and revaluation of music copyright	(0.7)		20.7	
Other recognised (losses) gains		(7.9)		48.7
Total recognised gains and losses relating to the year		48.4		(22.9)

* Net currency losses of £4.7m (2004: gains £4.5m), which relate to foreign currency borrowings to finance investment overseas, and the related tax charge of £nil (2004: £nil), have been included within the Group currency translation movement on reserves.

Reconciliation of movements in shareholders' funds

for the year ended 31 March 2005

	Note	£m	2005 £m	£m	2004 £m
Opening shareholders' funds			(784.0)		(700.4)
Profit (loss) for the financial year		56.3		(71.6)	
Shares issued		1.7		–	
Dividends (equity)	7	(63.2)		(62.5)	
Other recognised (losses) gains		(7.9)		48.7	
Goodwill adjustments		(0.3)		–	
Employee Benefit Trust transactions		2.0		1.8	
Net (decrease) increase in shareholders' funds for the year			(11.4)		(83.6)
Closing shareholders' funds			(795.4)		(784.0)

Consolidated cash flow statement and notes

for the year ended 31 March 2005

	Notes	2005 £m	2004 £m
Net cash inflow from operating activities	a	221.4	309.4
Returns on investments and servicing of finance			
Interest received		5.2	7.4
Interest paid		(105.5)	(102.7)
Interest element of finance lease payments		–	(0.1)
Dividends paid to minorities		(1.3)	(3.5)
Net cash outflow from returns on investments and servicing of finance		(101.6)	(98.9)
Tax paid		(32.7)	(30.6)
Capital expenditure and financial investment			
Purchase of music copyrights	10	(6.0)	(5.1)
Sale of music copyrights		0.2	0.4
Purchase of tangible fixed assets	12	(29.9)	(51.3)
Sale of tangible fixed assets		3.3	78.0
Purchase of investments: own shares	23	(0.3)	(0.3)
Purchase of fixed asset investments		(2.9)	–
Sale of fixed asset investments		–	1.0
Net cash (outflow) inflow from capital expenditure and financial investment		(35.6)	22.7
Acquisitions and disposals			
Purchase of businesses net of cash acquired	13	(6.8)	(73.3)
Deferred consideration paid		(64.1)	(16.1)
Purchase of associated undertakings	13	(2.1)	–
Disposal of associated undertakings		0.1	0.4
Net cash (outflow) inflow from acquisitions and disposals		(72.9)	(89.0)
Equity dividends paid		(62.9)	(62.7)
Net cash (outflow) inflow before management of liquid resources and financing		(84.3)	50.9
Issue of ordinary share capital		1.7	–
Management of liquid resources	b)	(0.8)	(1.7)
Financing:			
New loans	b)	128.9	398.5
Loans repaid	b)	(127.1)	(209.4)
Capital element of finance leases repaid	b)	(0.1)	(2.1)
Net cash inflow (outflow) from management of liquid resources and financing		2.6	185.3
(Decrease) increase in cash	b)	(81.7)	236.2

Reconciliation of net cash flow to movement in net debt

	2005 £m	2004 £m
(Decrease) increase in cash	(81.7)	236.2
Cash outflow from increase in liquid resources	0.8	1.7
Cash (inflow) from increase in loans	(128.9)	(398.5)
Cash (inflow) outflow from repayment of loans and finance leases	127.2	211.5
Change in net debt resulting from cash flows	(82.6)	50.9
Loans acquired	–	(0.4)
Exchange differences	1.8	60.6
Movement in net debt	(80.8)	111.1
Net debt at beginning of year	(748.7)	(859.8)
Net debt at end of year	(829.5)	(748.7)

a) Reconciliation of Group operating profit to net cash inflow from operating activities

	Notes	2005 £m	2004 £m
Group operating profit	1	182.2	60.1
Depreciation charge	12	23.9	35.0
Amortisation charge:			
Music copyrights	10	45.8	46.9
Goodwill	11	4.9	4.0
Exceptional non-cash write-down		–	43.1
Goodwill write-down – subsidiaries		–	18.1
Music copyrights write-down		–	4.5
ESOP transactions		2.3	2.1
Amounts provided	21	7.8	73.4
Provisions utilised:			
Disposals and fundamental reorganisations		(11.3)	–
Other		(59.4)	(36.1)
(Increase) decrease in working capital:			
Stock		(0.1)	(8.0)
Debtors		10.9	59.8
Creditors		14.4	6.5
Net cash inflow from operating activities		221.4	309.4

b) Analysis of movement in the Group's net borrowings

	At 1 April 2004 £m	Cash flow £m	Acquisitions/ disposals £m	Exchange movement £m	At 31 March 2005 £m
Cash at bank and in hand	342.7	(101.7)	–	(1.9)	239.1
Overdrafts	(32.5)	20.0	–	0.7	(11.8)
Cash	310.2	(81.7)	–	(1.2)	227.3
Debt due after more than one year	(1,058.0)	13.2	–	2.8	(1,042.0)
Debt due within one year	(3.3)	(15.0)	–	0.1	(18.2)
Finance leases	(0.1)	0.1	–	–	–
Financing*	(1,061.4)	(1.7)	–	2.9	(1,060.2)
Investments: liquid funds	1.8	(0.3)	–	0.1	1.6
Cash deposits	0.7	1.1	–	–	1.8
Liquid resources	2.5	0.8	–	0.1	3.4
Total	(748.7)	(82.6)	–	1.8	(829.5)

* Cash flow on financing of £(1.7)m is split between new loans of £(128.9)m, loans repaid of £127.1m and the capital element of finance leases repaid of £0.1m.

	At 1 April 2003 £m	Cash flow £m	Acquisitions/ disposals £m	Exchange movement £m	At 31 March 2004 £m
Cash at bank and in hand	99.9	245.4	0.4	(3.0)	342.7
Overdrafts	(25.0)	(9.6)	–	2.1	(32.5)
Cash	74.9	235.8	0.4	(0.9)	310.2
Debt due after more than one year	(920.5)	(198.9)	–	61.4	(1,058.0)
Debt due within one year	(12.8)	9.8	(0.4)	0.1	(3.3)
Finance leases	(2.2)	2.1	–	–	(0.1)
Financing*	(935.5)	(187.0)	(0.4)	61.5	(1,061.4)
Investments: liquid funds	0.5	1.3	–	–	1.8
Cash deposits	0.3	0.4	–	–	0.7
Liquid resources	0.8	1.7	–	–	2.5
Total	(859.8)	50.5	–	60.6	(748.7)

* Cash flow on financing of £(187.0)m is split between new loans of £(398.5)m, loans repaid of £209.4m and the capital element of finance leases repaid of £2.1m.

Cash: Cash in hand and deposits repayable on demand if available within 24 hours without penalty, including overdrafts.
Financing: Borrowings, less overdrafts which have been treated as cash.
Liquid resources: Investments and deposits, other than those included as cash, which are readily convertible into known amounts of cash.

Accounting policies

Basis of preparation
The consolidated financial statements are prepared under the historical cost convention with the exception of certain tangible fixed assets and in accordance with applicable accounting standards. The results for the years ended 31 March 2005 and 31 March 2004 represent continuing operations.

Basis of consolidation
The consolidated financial statements comprise the accounts of the Company and its subsidiaries. The results of all subsidiaries are taken from their accounts made up to 31 March or such earlier date (not prior to 31 December) which represents their financial period end, as adjusted for material items that have occurred in the intervening period. The results of subsidiaries, joint ventures and associated undertakings disposed of or acquired during the year are included up to, or from, the date that control passes.

Foreign currencies
Transactions denominated in foreign currencies are recorded at the rates of exchange ruling at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies are retranslated into Sterling either at year-end rates or, where there are related forward foreign exchange contracts, at contract rates. The resulting exchange differences are dealt with in the determination of profit for the financial year.

On consolidation, average exchange rates have been used to translate the results of overseas subsidiaries, joint ventures and associated undertakings. The assets and liabilities of overseas subsidiaries and associated undertakings are translated into Sterling at year-end rates.

Exchange differences arising from the retranslation at year-end exchange rates of:
(i) the opening net investment in overseas subsidiaries, joint ventures and associated undertakings and foreign currency borrowings in so far as they are matched by those overseas investments; and
(ii) the results of overseas subsidiaries, joint ventures and associated undertakings:
are dealt with in Group reserves.

Turnover
Turnover represents the invoiced value or contracted amount of goods and services supplied by the Company and its subsidiaries. Turnover is stated net of actual product returns and excludes value added tax and similar sales-related taxes. Provision is also made in respect of expected future returns of goods and services supplied by the Company and its subsidiaries prior to the balance sheet date.

Pension costs
Pension costs, which are determined in accordance with SSAP 24 - *Accounting for Pension Costs* are charged to the profit and loss account so as to spread the cost of pensions over the working lives of the employees within the Group. Valuation surpluses or deficits are amortised over the expected remaining working life within the Group of the relevant employees (estimated to be nine years in respect of the UK). The amortisation of valuation surpluses is restricted to an amount equal to the regular pension cost. Accordingly, employer expense in respect of the main scheme, which covers employees in the UK, has been taken as £nil for each of the two years ended 31 March 2005.

Joint ventures and associated undertakings
Where the Group has an investment in an entity which is sufficient to give the Group a participating interest, and over which it is in a position to exercise significant influence, the entity is treated as an associated undertaking and is accounted for using the equity method. Entities in which the Group holds an interest on a long-term basis and which are jointly controlled by the Group and one or more other parties under a contractual arrangement, are treated as joint ventures and are accounted for using the gross equity method.

The results of joint ventures and associated undertakings are taken from their accounts made up to 31 March or such earlier date (not prior to 31 December) which represents their financial period end, as adjusted for material items that have occurred in the intervening period.

New media holdings
Holdings in new media companies that arise as a consequence of licensing, distribution and other similar deals with such companies, are carried at cost. Income from these holdings, net of costs, is only recognised when received as cash and is treated as other operating income. The costs relating to these investments are held within debtors until they are recognised with the related income.

Music copyrights
Music copyrights purchased prior to 1 April 1989 were written off against shareholders' funds on acquisition. Copyrights acquired as a result of acquisitions on or after 1 April 1989 are capitalised as intangible assets in the Group balance sheet, and are amortised by equal annual amounts over not more than 20 years, other than in exceptional circumstances when sufficient ongoing impairment tests can be performed to support a useful economic life of over 20 years. Where a useful economic life of up to 20 years has been adopted, copyrights are reviewed for impairment at the end of the first full financial year following acquisition and in other periods if events or changes in circumstances indicate that the carrying value may not be recoverable.

Goodwill and other intangibles
Goodwill and recorded catalogue intangibles arising on acquisitions made after 31 March 1998 are capitalised and amortised over their expected useful life, principally restricted to 20 years, in accordance with FRS10 - *Goodwill and Intangible Assets*. They are reviewed for impairment at the end of the first full financial year following acquisition and in other periods if events or changes in circumstances indicate that the carrying value may not be recoverable.

Goodwill arising on acquisitions made before 31 March 1998 has been charged directly against shareholders' funds in the year of acquisition and is included within the profit and loss reserve, yet separately identified within the reserves note. This goodwill will remain in reserves until, on the disposal or closure of any business, the profit and loss account includes a charge in respect of the goodwill previously written off against shareholders' funds on the acquisition of the business.

Tangible fixed assets
Assets are held at historical cost with the exception that certain properties in the subsidiary undertaking Toshiba-EMI Limited are carried at revalued amounts that were frozen as permitted on first-time adoption, under the transitional rules, of FRS 15 – *Tangible Fixed Assets*. The frozen carrying value was deemed cost in the case of these properties.

Leased assets
Assets held under finance leases are included as tangible fixed assets at their estimated purchase cost and depreciated over their expected useful lives, or over the primary lease period, whichever is shorter. The obligations relating to finance leases (net of finance charges allocated to future periods) are included under borrowings due within or after one year, as appropriate. Operating lease rentals are charged to the profit and loss account on a straight-line basis over the lease term.

Depreciation of tangible fixed assets
Depreciation of tangible fixed assets is calculated on cost at rates estimated to write off the cost, less the estimated residual value of the relevant assets, by equal annual amounts over their expected useful lives; effect is given, where necessary, to commercial and technical obsolescence.

The annual rates used are:

Freehold buildings and long-term leasehold property	2%
Short-term leasehold property	Period of lease
Plant, equipment and vehicles	10-33 ⅓%

The carrying values of tangible fixed assets are reviewed for impairment in periods if events or changes in circumstances indicate the carrying value may not be recoverable.

Assets in the course of construction are held at cost and are depreciated from the date the asset comes into use.

Stocks
Stocks and work in progress are stated at the lower of cost and net realisable value, less progress payments on uncompleted contracts and provisions for expected losses. Cost includes manufacturing overheads where appropriate.

Advances to artists
Advances to artists and repertoire owners are assessed and the value of the unrecouped portion to be included in debtors is determined by the prospects of future recoupment, based on past sales performance, current popularity and projected sales.

Taxation
The Company has undertaken to discharge the liability to corporation tax of the majority of its wholly-owned UK subsidiaries. Their UK tax liabilities are therefore dealt with in the accounts of the Company.

Deferred tax is recognised in respect of all timing differences that have originated but not reversed at the balance sheet date, where transactions or events have occurred at that date that will result in an obligation to pay more tax, or right to pay less, or to receive more, tax, with the following exceptions:

- Provision is made for tax on gains arising from the revaluation (and similar fair value adjustments) of fixed assets, or gains on disposal of fixed assets, only to the extent that, at the balance sheet date, there is a binding agreement to dispose of the assets concerned. However, no provision is made where, on the basis of all available evidence at the balance sheet date, it is more likely than not that the taxable gain will be rolled over into replacement assets.
- Provision is made for gains which have been rolled over into replacement assets only to the extent that, at the balance sheet date, there is a commitment to dispose of the replacement assets.
- Provision is made for deferred tax that would arise on remittance of the retained earnings of overseas subsidiaries, associates and joint ventures only to the extent that, at the balance sheet date, dividends have been accrued as receivable.
- Deferred tax assets are recognised only to the extent that the Directors consider that it is more likely than not that there will be suitable taxable profits from which the underlying timing differences can be deducted.

Deferred tax is measured on an undiscounted basis at the tax rates that are expected to apply in the periods in which timing differences reverse, based on tax rates and laws enacted or substantively enacted at the balance sheet date.

Financial instruments
Any premium or discount associated with the purchase of interest rate instruments is amortised over the life of the transaction. Interest receipts and payments are accrued to match the net income or cost with the related finance expense. No amounts are recognised in respect of future periods.

Directly attributable issue costs have been reported as a reduction in the proceeds of the relevant capital instrument and are amortised over the life of the instrument.

Notes to the financial statements

for the year ended 31 March 2005

1. Segmental analyses

	EMI Music £m	EMI Music Publishing £m	2005 Total £m	EMI Music £m	EMI Music Publishing £m	2004 Total £m
By class of business:						
Group turnover	1,542.1	400.7	1,942.8	1,722.8	397.9	2,120.7
Group operating profit (loss) before exceptional items and amortisation	132.7	100.2	232.9	147.4	101.9	249.3
Operating exceptional items and amortisation	(7.9)	(42.8)	(50.7)	(132.7)	(56.5)	(189.2)
Group operating profit (loss)	124.8	57.4	182.2	14.7	45.4	60.1
Non-operating exceptional items	0.8	–	0.8	(16.5)	–	(16.5)
Share of operating profits (losses) in associated undertakings	0.4	0.5	0.9	(0.4)	0.1	(0.3)
Finance charges			(92.1)			(96.1)
Profit (loss) on ordinary activities before taxation			91.8			(52.8)
Operating assets (liabilities)	(3.4)	341.3	337.9	(45.7)	343.7	298.0
Average employees (No.)	6,043	629	6,672	7,373	623	7,996

	United Kingdom £m	Rest of Europe £m	Latin America £m	North America £m	Asia Pacific £m	Other £m	2005 Total £m
By origin:							
Group turnover	305.8	618.1	55.8	574.9	365.2	23.0	1,942.8
Group operating profit (loss) before exceptional items and amortisation	48.7	86.6	3.2	70.9	18.9	4.6	232.9
Operating exceptional items and amortisation*	(5.5)	(6.3)	(0.6)	(36.1)	(2.2)	–	(50.7)
Group operating profit (loss)	43.2	80.3	2.6	34.8	16.7	4.6	182.2
Non-operating exceptional items							0.8
Share of operating profits (losses) in associated undertakings							0.9
Finance charges							(92.1)
Profit (loss) on ordinary activities before taxation							91.8
Operating assets (liabilities)	65.8	(45.8)	0.6	265.1	52.9	(0.7)	337.9
Average employees (No.)	1,156	1,623	239	2,124	1,345	185	6,672
By destination:							
Group turnover	299.0	619.7	33.2	578.0	366.3	46.6	1,942.8

	United Kingdom £m	Rest of Europe £m	Latin America £m	North America £m	Asia Pacific £m	Other £m	2004 Total £m
By origin:							
Group turnover	308.6	651.1	44.6	671.9	423.6	20.9	2,120.7
Group operating profit (loss) before exceptional items and amortisation	53.6	62.0	(1.8)	99.2	32.5	3.8	249.3
Operating exceptional items and amortisation*	(39.1)	(58.0)	(1.1)	(62.1)	(25.2)	(3.7)	(189.2)
Group operating profit (loss)	14.5	4.0	(2.9)	37.1	7.3	0.1	60.1
Non-operating exceptional items							(16.5)
Share of operating profits (losses) in associated undertakings							(0.3)
Finance charges							(96.1)
Profit (loss) on ordinary activities before taxation							(52.8)
Operating assets (liabilities)	17.8	(52.3)	(0.6)	256.8	76.7	(0.4)	298.0
Average employees (No.)	1,199	2,338	324	2,464	1,403	268	7,996
By destination:							
Group turnover	304.4	649.2	21.5	678.9	422.1	44.6	2,120.7

* Comprises operating exceptional items of £nil (2004: £(138.3)m) and amortisation of goodwill and music copyrights of £(50.7)m (2004: £(50.9)m).

Operating profit is analysed instead of profit before taxation as finance charges are borne centrally and are not allocated to the operating businesses. Operating assets include deferred consideration of £0.9m (2004: £69.8m) which is not conditional upon the satisfaction of future performance criteria.

The reconciliation of operating assets to net liabilities is as follows:

	Note	2005 £m	2004 £m
Operating assets		337.9	298.0
Tax, dividends and net interest payable		(255.5)	(265.7)
Capital employed		82.4	32.3
Net borrowings	16	(829.5)	(748.7)
Net liabilities		(747.1)	(716.4)

2. Group operating profit

	2005 £m	2004 £m
An analysis of costs (income) is as follows:		
Cost of sales	1,225.3	1,404.7
Cost of sales is analysed as:		
– normal	1,179.5	1,286.0
– exceptional items and music copyright amortisation	45.8	118.7
Net operating expenses:		
Distribution costs	69.6	92.0
Administration expenses	504.0	583.5
Other operating income, net*	(38.3)	(19.6)
	535.3	655.9
Net operating expenses are analysed as:		
– normal	530.4	585.4
– exceptional items and goodwill amortisation	4.9	70.5

* Other operating income principally comprises the Group's share of income from joint marketing arrangements.

	2005 £m	2004 £m
Operating profit is stated after charging:		
Amortisation of music copyrights	45.8	46.9
Amortisation of goodwill	4.9	4.0
Depreciation of tangible fixed assets	23.9	35.0
Operating lease rentals:		
Property	29.5	26.4
Plant, equipment and vehicles	3.4	4.2
Research and development expenditure	–	0.1

3. Fees to auditors

	2005 £m	2004 £m
Audit fees paid to Ernst & Young LLP	2.4	2.3
Audit fees paid to other firms	0.1	0.1
Other fees paid to Ernst & Young LLP*:		
UK	0.1	0.9
Non-UK	0.4	0.5
Total	3.0	3.8

* Other fees include £0.3m (2004: £0.5m) paid to Ernst & Young LLP for tax compliance and planning services, and £0.2m (2004: £0.9m) for regulatory and other assurance.

4. Directors' and employees' costs

	2005 £m	2004 £m
Aggregate emoluments paid to Directors	9.7	7.4
Wages and salaries	277.7	324.2
Social security costs	41.4	49.1
Other pension costs (see Note 27)	10.9	12.8
Total	339.7	393.5

Details of each Director's remuneration, compensation for loss of office, pension entitlements, long-term incentive scheme interests and share options are included in the Remuneration report.

5. Finance charges

	£m	2005 £m	£m	2004 £m
Interest payable on:				
Bank overdrafts and loans	81.7		72.3	
Other	13.2		17.3	
		94.9		89.6
Interest receivable on:				
Bank balances	(2.2)		(2.0)	
Other	(0.6)		(1.7)	
		(2.8)		(3.7)
Group finance charges (including associated undertakings)*		92.1		85.9
Finance exceptional charge (Note 8(iii))		–		10.2
Total		92.1		96.1

* Finance charges for associated undertakings are £nil (2004: £nil).

Finance charges include £6.6m (2004: £5.8m) of one-off costs, charges or expenses that are not continuing, regular or periodic.

The Group holds various financial instruments in order to manage interest rate risk. Details of those financial instruments held at the year end are given in Note 17 (viii).

The Group reported issue costs directly attributable to new debt instruments in the prior year as a reduction from the proceeds, as required by FRS4 – *Capital Instruments*. £10.2m was charged against profit in respect of programme costs not directly attributable to new instruments.

6. Taxation

	2005 £m	2004 £m
(i) Analysis of tax charge in year		
Current tax:		
UK corporation tax	4.3	5.3
Double taxation relief	(4.3)	(5.3)
	–	–
Withholding tax	7.1	9.5
Other foreign tax	28.2	17.4
Adjustments in respect of prior periods	(6.9)	(2.8)
Total current tax	28.4	24.1
Deferred tax:		
Origination and reversal of timing differences	2.8	(4.5)
Others:		
Associated undertakings	–	0.1
Tax on profit on ordinary activities	31.2	19.7
(ii) Factors affecting current tax charge for year		
Profit (loss) on ordinary activities before tax	91.8	(52.8)
Tax at weighted average rate	36.6	(20.4)
Effects of:		
Expenses not deductible for tax purposes	24.1	60.3
Timing differences	(3.3)	(2.5)
Utilisation of tax losses and other credits, principally in the US	(45.0)	(59.2)
Origination of tax losses	15.7	39.2
Withholding tax and other	0.3	6.7
Total current tax	28.4	24.1

The weighted average tax rate is calculated by applying statutory tax rates to actual taxable profits and losses in the countries of operation.

The prior-year UK corporation tax charge included the attributable taxation charge relating to non-operating exceptional items falling within the UK tax jurisdiction.

(iii) Factors that may affect future tax charges

No provision has been made for deferred tax where potentially taxable gains have been rolled over into replacement assets, except where there is a commitment to dispose of these assets. Such gains would only become taxable if the assets were sold without it being possible to claim roll-over relief or offset existing capital losses. The Group does not expect any such tax to become payable in the foreseeable future.

No deferred tax has been recognised in respect of tax on gains arising from the revaluation of fixed assets, as the Group is not committed to the disposal of these assets. No deferred tax has been recognised in respect of the earnings of overseas subsidiaries as no dividends have been accrued.

Deferred tax assets which have not been recognised are tax losses and credits with a value of £124.2m, capital allowances in advance of depreciation with a value of £8.8m, and other timing differences with a value of £12.7m, as there is insufficient certainty as to the availability of future taxable profits.

7. Dividends (equity)

	2005 Per share	2004 Per share	2005 £m	2004 £m
Ordinary dividends (net):				
Interim	2.0p	2.0p	15.7	15.8
Adjustment to 2005 and 2004 interim	–	–	–	(0.1)
Proposed final	6.0p	6.0p	47.4	47.1
Adjustment to 2004 and 2003 final	–	–	0.1	(0.3)
Total	8.0p	8.0p	63.2	62.5

Subject to the approval of shareholders, the final dividend of 6.0p per share will be paid on 7 October 2005 to shareholders on the register at the close of business on 9 September 2005.

8. Exceptional items

(i) Operating exceptional items

	2005 £m	2004 £m
Impact of destocking in Japan, including amended return terms	–	(16.7)
Restructuring and reorganisation costs:		
EMI Music Publishing: headcount reduction and system write-offs	–	(6.6)
EMI Music: headcount and roster reduction and other*	(3.8)	(84.5)
Release of overprovision for reorganisation costs charged in prior year	3.8	–
Asset impairment and other**	–	(22.6)
Proposed acquisition of Warner Music – deal costs	–	(7.9)
Total	–	(138.3)

* Headcount reduction (£3.8m) (2004: headcount reduction (£51.7m), roster reduction (£20.6m), vacant property provisions and asset write-downs (£3.5m), distribution changes and integration costs (£4.6m) and other (£4.1m)).
** (2004: write-downs of music copyrights (£4.5m) and goodwill (£18.1m)).

The attributable taxation credit relating to operating exceptional items is £nil (2004: £14.4m).

In 2004, assets were written down to their net realisable value or to a value in use based on a discounted cash flow projection. Discount rates of 6% to 14% were applied in the impairment reviews completed during that year. The discount rates were appropriate to the divisions and the assets being valued.

The share of the operating exceptional items attributable to minority interests is £0.2m (2004: £7.2m).

(ii) Non-operating exceptional items

	2005 £m	2004 £m
Losses on sale and closure of manufacturing business*	–	(45.5)
Net gain on sale of fixed assets and investments**	0.8	24.0
Profit on sale of HMV Group plc***	–	5.0
Total	0.8	(16.5)

* (2004: costs of redundancies (£11.8m), losses on sale or decommissioning of fixed assets (£12.1m), losses on sales of stocks (£12.0m) and integration costs (£9.6m)).
** Comprises gains (losses) on sale of properties (2004: gains (losses) on sale of properties).
*** (2004: release of a provision to cover EMI Group plc's pension liability no longer required).

The attributable taxation charge relating to non-operating exceptional items is £nil (2004: £1.6m).

(iii) Finance exceptional charge

	2005 £m	2004 £m
Costs incurred as part of the Group's refinancing programme (see Note 5)	–	(10.2)
Total	–	(10.2)

9. Earnings per Ordinary Share

	2005	2004
Earnings per Ordinary Share is calculated as follows:		
Earnings	£56.3m	£(71.6)m
Adjusted earnings	£106.3m	£124.3m
Basic		
Weighted average number of Ordinary Shares in issue	785.6m	784.4m
Diluted		
Adjusted weighted average number of Ordinary Shares	872.8m	826.5m

The adjusted weighted average number of Ordinary Shares used in the diluted earnings per share calculations, 872.8m (2004: 826.5m), is the weighted average number of Ordinary Shares in issue, 785.6m (2004: 784.4m), plus adjustments for dilutive share options, 8.4m (2004: 2.9m), plus adjustments for convertible bond options, 78.9m (2004: 39.2m).

Adjusted earnings are included as they provide a better understanding of the underlying trading performance of the Group on a normalised basis.

Reconciliation of adjusted earnings

	Year ended 31 March 2005 £m	Per share	Year ended 31 March 2004 £m	Per share
Earnings/basic EPS	56.3	7.2p	(71.6)	(9.1)p
Adjustments:				
Exceptional items and attributable taxation	(0.8)	(0.1)p	152.2	19.3p
Amortisation of goodwill and music copyrights	50.9	6.4p	51.1	6.5p
Minority interest (re music copyright amortisation)	(0.3)	0.0p	(0.4)	0.0p
Minority interest (re operating exceptional items and attributable taxation)	0.2	0.0p	(7.0)	(0.9)p
Adjusted earnings/adjusted EPS	106.3	13.5p	124.3	15.8p
Convertible bond	6.9	(0.5)p	3.7	(0.3)p
Adjusted earnings/adjusted diluted EPS	113.2	13.0p	128.0	15.5p

10. Music copyrights

Group

	£m
Cost at 31 March 2004	783.6
Currency retranslation	(13.9)
Additions	6.0
Disposals	(1.8)
Other	0.3
Cost at 31 March 2005	774.2
Amortisation at 31 March 2004	334.9
Currency retranslation	(7.2)
Charge for year	45.8
Disposals	(1.6)
Write-down of music copyrights	–
Other	(0.5)
Amortisation at 31 March 2005	371.4
Net book values at 31 March 2005	402.8
31 March 2004	448.7

11. Goodwill (capitalised)

Group

	£m
Cost at 31 March 2004	71.8
Currency retranslation	0.2
Acquisition of businesses	5.9
Cost at 31 March 2005	**77.9**
Amortisation at 31 March 2004	40.0
Currency retranslation	(0.2)
Charge for year	4.9
Amortisation at 31 March 2005	**44.7**
Net book values at 31 March 2005	**33.2**
31 March 2004	31.8

12. Tangible fixed assets

Group

	Freehold property £m	Leasehold property £m	Plant, equipment and vehicles £m	Total £m
Cost at 31 March 2004	132.9	62.1	208.6	403.6
Currency retranslation and reclassification	(13.5)	(0.9)	(24.5)	(38.9)
Acquisition of businesses	–	–	–	–
Disposal of businesses	–	–	(4.6)	(4.6)
Additions	2.5	1.8	25.6	29.9
Disposals	(6.1)	(0.4)	(12.8)	(19.3)
Impairment of revalued property	(18.5)	–	–	(18.5)
Cost at 31 March 2005	**97.3**	**62.6**	**192.3**	**352.2**
Depreciation at 31 March 2004	29.6	16.1	155.2	200.9
Currency retranslation and reclassification	(2.6)	(0.2)	(33.4)	(36.2)
Disposal of businesses	–	–	(2.8)	(2.8)
Charge for year	2.3	2.9	18.7	23.9
Disposals	(4.4)	(0.4)	(11.9)	(16.7)
Depreciation at 31 March 2005	**24.9**	**18.4**	**125.8**	**169.1**
Net book values at 31 March 2005	**72.4**	**44.2**	**66.5**	**183.1**
31 March 2004	103.3	46.0	53.4	202.7

Freehold property includes land having a cost of £31.6m (2004: £52.9m) which is not depreciated. The depreciation charge for the year includes depreciation of assets held under finance leases of £nil (2004: £nil).

The impairment charge results from a comparison of the carrying value with the higher of net realisable value and value in use.

Group

	2005 £m	2004 £m
The net book values shown above include the following:		
Long-term leasehold property	4.8	4.2
Short-term leasehold property	39.4	41.8
Finance lease assets	–	0.1
Assets in the course of construction	17.4	3.5

Properties held by Toshiba-EMI Limited were carried at a revalued amount prior to the implementation of FRS15 - *Tangible Fixed Assets* in the year ended 31 March 2000. The revalued amount was based on third party expert valuation. Under the transitional arrangements of that standard, the carrying value of these properties has been retained. These properties are currently held at net book value of £37.2m (2004: £59.2m). The comparable amount under the historical cost convention would be £14.3m (2004: £15.7m).

Company

	Freehold property £m	Leasehold property £m	Plant, equipment and vehicles £m	Total £m
Cost at 31 March 2004	8.8	24.9	14.9	48.6
Additions	–	–	–	–
Disposals and transfers	(4.4)	(0.9)	(12.4)	(17.7)
Cost at 31 March 2005	**4.4**	**24.0**	**2.5**	**30.9**
Depreciation at 31 March 2004	2.0	3.7	11.2	16.9
Charge for year	0.1	1.5	0.1	1.7
Disposals and transfers	(1.3)	(0.3)	(9.4)	(11.0)
Depreciation at 31 March 2005	**0.8**	**4.9**	**1.9**	**7.6**
Net book values at 31 March 2005	**3.6**	**19.1**	**0.6**	**23.3**
31 March 2004	6.8	21.2	3.7	31.7

13. Fixed asset investments

	Group 2005 £m	Group 2004 £m	Company 2005 £m	Company 2004 £m
Investments comprise:				
Subsidiary undertakings	–	–	2,225.0	2,210.9
Associated undertakings	8.1	5.4	0.6	0.6
Other fixed asset investments	14.8	13.9	0.3	0.2
Total	22.9	19.3	2,225.9	2,211.7
Listed investments	2.6	–	–	–
Unlisted investments	20.3	19.3	2,225.9	2,211.7
	22.9	19.3	2,225.9	2,211.7

The market value of listed investments at 31 March 2005 was £2.7m (2004: £nil).

(i) Investments in subsidiary undertakings

Company

	Cost of shares £m	Loans £m	Provisions £m	Net book value £m
At 31 March 2004	2,027.0	304.4	(120.5)	2,210.9
Additions	–	14.6	–	14.6
Disposals, transfers and other movements	–	(0.5)	–	(0.5)
At 31 March 2005	2,027.0	318.5	(120.5)	2,225.0

The subsidiary undertakings set out below are those which were part of the Group at 31 March 2005 and in the opinion of the Directors significantly affected the Group's results and net assets during the year. Except where otherwise stated, the country of incorporation is England, the operations are within the United Kingdom, the shares are in equity share capital and the businesses are wholly owned.

Recorded Music and Music Publishing
Capitol-EMI Music, Inc. (USA)
Capitol Records, Inc. (USA)
Chrysalis Records Ltd
EMI Music Germany GmbH & Co.KG
EMI Entertainment World, Inc. (USA)
EMI Music Australia Pty Ltd (Australia)
EMI Music France S.A. (France)
EMI Music Italy SpA (Italy)
EMI Music Publishing Ltd
EMI Records Ltd
Jobete Music Co., Inc. (USA)
Priority Records, LLC (USA)
Toshiba-EMI Ltd (Japan) (55% owned)
Virgin Records America, Inc. (USA)
Virgin Records Ltd

Corporate
EMI Group Finance plc*
EMI Group Finance (Jersey) Ltd*
EMI Group Holdings (UK) Ltd
EMI Group International Holdings Ltd
EMI Group North America Holdings, Inc. (USA)
EMI Group North America, Inc. (USA)
EMI Group Worldwide Ltd
Virgin Music Group Ltd*

* Held directly by the company.

13. Fixed asset investments (continued)

Purchase of businesses

The Group did not acquire any businesses during the year.

On 2 April 2004, the Group purchased the outstanding 10% minority interest in EMI Greece for a cash consideration of £3.1m. This, combined with £0.4m of consideration paid in advance during the last financial year, resulted in £3.5m additional goodwill being created.

On 1 October 2004, the Group purchased the outstanding 49% minority interest in EMI Poland for a cash consideration of £2.9m. The transaction resulted in £1.9m additional goodwill being created.

A further £0.7m of cash consideration was paid to acquire outstanding minority interests in Indonesia and the Netherlands and to satisfy additional consideration commitments in Sweden, South Korea and the UK.

(ii) Associated undertakings

Group

	Net equity investment £m	Goodwill written off £m	Share of net assets £m	Capitalised goodwill £m	Loans £m	Net book value £m
At 31 March 2004	46.1	(43.4)	2.7	2.2	0.5	5.4
Currency retranslation	(0.2)	–	(0.2)	–	–	(0.2)
Additions* and new loans	2.1	–	2.1	–	–	2.1
Net profits after tax	1.1	–	1.1	(0.2)	–	0.9
Disposals, provisions and loans repaid	(0.1)	–	(0.1)	–	–	(0.1)
At 31 March 2005	**49.0**	**(43.4)**	**5.6**	**2.0**	**0.5**	**8.1**

* Total consideration on purchase of associated undertakings comprises costs and loans totalling £2.1m (2004: £0.1m).

Company

	Cost of shares £m	Provisions £m	Net book value £m
At 31 March 2004	0.7	(0.1)	0.6
At 31 March 2005	**0.7**	**(0.1)**	**0.6**

The Company holds investments at cost, less provisions for impairment.

(iii) Other fixed asset investments

	Group Cost of shares £m	Group Provisions £m	Group Net book value £m	Company Cost of shares £m	Company Provisions £m	Company Net book value £m
At 31 March 2004	19.8	(5.9)	13.9	2.5	(2.3)	0.2
Purchases	(0.2)	–	(0.2)	0.1	–	0.1
Currency retranslation	2.9	–	2.9	–	–	–
Disposals and reclassifications	(1.8)	–	(1.8)	–	–	–
At 31 March 2005	**20.7**	**(5.9)**	**14.8**	**2.6**	**(2.3)**	**0.3**

Notes to the financial statements

continued

14. Stocks

	Group 2005 £m	Group 2004 £m	Company 2005 £m	Company 2004 £m
Raw materials and consumables	1.5	1.8	–	–
Work in progress	2.0	1.7	–	–
Finished goods	24.7	24.6	–	–
Total	28.2	28.1	–	–

15. Debtors

	Group 2005 £m	Group 2004 £m	Company 2005 £m	Company 2004 £m
Due within one year:				
Trade debtors	300.1	345.3	–	0.9
Amounts owed by subsidiary undertakings	–	–	2,459.5	2,422.3
Amounts owed by associated undertakings	0.5	0.8	–	–
Corporate taxation recoverable	21.2	13.4	–	–
Other debtors	95.4	72.9	5.5	9.3
Prepayments and accrued income	285.9	271.0	0.8	0.3
Deferred tax	17.7	19.2	–	–
	720.8	722.6	2,465.8	2,432.8
Due after more than one year:				
Other debtors	6.6	7.8	–	0.4
Prepayments and accrued income	72.9	80.5	–	–
	79.5	88.3	–	0.4
Total	800.3	810.9	2,465.8	2,433.2

Other debtors due within one year includes £0.9m (2004: £1.6m) book value of listed investments with a market value of £1.6m (2004: £2.1m).

16. Borrowings

	Due date	Issue date	Group 2005 £m	Group 2004 £m	Company 2005 £m	Company 2004 £m
Long-term borrowings						
US$500m 8.375% Guaranteed Notes	August 2009	August 1999	263.2	269.6	–	–
£325m 8.25% Sterling Bonds	May 2008	May 2002	322.1	321.3	322.2	321.3
US$123.8m 6.96% Senior Notes	August 2007	August 2002	48.7	67.3	–	–
US$243.3m 5.25% Guaranteed Convertible Bonds *	October 2010	October 2003	123.5	126.0	–	–
€425m 8.625% Senior Notes	October 2013	October 2003	285.3	274.8	282.5	274.8
Drawings under long-term committed facilities **			(1.9)	(2.9)	(1.9)	(2.9)
Term loan	December 2006		1.1	1.9	–	–
Finance leases			–	0.1	–	–
Total long-term borrowings			1,042.0	1,058.1	602.8	593.2
Short-term borrowings						
Loans and overdrafts			11.8	34.7	–	–
Finance leases			–	–	–	–
Short-term element of long-term loans ***			18.2	1.1	–	–
Total short-term borrowings			30.0	35.8	–	–
Total borrowings			1,072.0	1,093.9	602.8	593.2
Liquid funds:						
Investments: liquid funds			(1.6)	(1.8)	–	–
Cash at bank and in hand and cash deposits			(240.9)	(343.4)	(1.3)	(5.0)
Net borrowings			829.5	748.7	601.5	588.2

* These will be convertible into fully-paid Preference Shares of the issuer which will be exchangeable immediately upon issue for fully-paid Ordinary Shares in EMI Group plc. On conversion each US$ principal amount is converted into one Preference Share of a paid-up value of US$1,000. The Preference Share will, in turn, be immediately exchangeable for Ordinary Shares in EMI Group plc. The number of Ordinary Shares for which a Preference Share may be exchanged will be determined by dividing the paid-up value of the Preference Share, translated into Sterling at a fixed rate of US$1.5957, by the exchange price initially set at 193.38p per Ordinary Share. Conversion by the holder at 193.38p per Ordinary Share may occur after 11 November 2003 until seven days prior to the final redemption date. Conversion by the issuer, after 16 October 2007, of all but not part, may occur if the average price per Ordinary Share on at least 20 dealing days in any period of 30 consecutive dealing days has been 130p; or at any time if 85% or more of the aggregate principal amount has been previously purchased, redeemed or cancelled. Redemption by the issuer, after 16 October 2007, may occur if the same conditions which apply to conversion by the issuer are met. Final redemption is on 2 October 2010 at 100% of principal and accrued interest.

** Issue costs relating to syndicated revolving credit facility in 2004.

*** Includes a £16.4m prepayment of the US$123.8m 6.96% Senior Notes due in August 2005.

On 15 July 2004, the Group signed an additional 364 day £100m committed credit facility with a group of banks.

On 2 and 3 October 2003, the Group completed a major restructuring of its borrowings. Five separate but related transactions were completed:
(a) the issue of €425m 8.625% Senior Notes due 2013;
(b) the issue of US$243.3m Guaranteed Convertible Bonds due 2010, unless previously redeemed, converted or purchased and cancelled;
(c) the cancellation of the existing revolving credit bank facilities expiring 2005;
(d) the finalisation of a new £250m revolving credit bank facility expiring 2007 (see Note 17(v) for level of undrawn facilities as at 31 March 2005); and
(e) prepayment of US$25m Senior Notes due 2012 and US$31.25m Senior Notes due 2009.

Long-term borrowings include £nil (2004: £nil) of borrowings repayable within one year, which are drawings under long-term committed facilities and, therefore, have been classified as such. Long-term borrowings are stated after deduction of issue costs which are capitalised and amortised over the term of the borrowing. Issue costs are defined as incremental costs that are incurred directly in connection with the issue of a capital instrument and include arrangement and underwriting fees.

Under their banking arrangements, overdraft and cash balances of the Company and of certain subsidiaries are pooled or offset and cross-guaranteed. Such pooling and offsets are reflected in the Group Balance sheet as appropriate.

The Group has balances of cash and liquid funds totalling £113.1m held with banks within the UK and £129.4m held with banks outside, but freely transferable to, the UK.

Maturity analysis of long-term borrowings

	Group 2005 £m	Group 2004 £m	Company 2005 £m	Company 2004 £m
Amounts falling due after more than one year are repayable as follows:				
Between one and two years	1.1	2.0	–	–
Between two and five years	632.1	385.7	–	–
After five years:				
By instalments	–	–	–	–
Other	408.8	670.4	602.8	593.2
Total	1,042.0	1,058.1	602.8	593.2

The amount of debt, any of which falls due for payment after more than five years, is £408.8m (2004: £670.4m).

17. Derivatives and other financial instruments

The Group has excluded all short-term debtors and creditors from the following disclosures, other than currency exposures.

(i) Interest rate risk profile of the financial liabilities of the Group

Currency	At 31 March 2005 Total* £m	Floating rate financial liabilities £m	Fixed rate financial liabilities £m	Financial liabilities on which no interest is paid £m	At 31 March 2004 Total* £m	Floating rate financial liabilities £m	Fixed rate financial liabilities £m	Financial liabilities on which no interest is paid £m
Sterling	321.4	(0.8)**	322.1	0.1	319.8	(1.7)**	321.3	0.2
US Dollar	462.6	266.1	188.6	7.9	481.0	277.8	193.3	9.9
Yen	2.1	–	–	2.1#	19.6	17.3	–	2.3#
Euro	288.4	288.4	–	–	276.8	276.8	–	–
Other	7.7	7.6	–	0.1	9.6	9.1	–	0.5
Total	1,082.2	561.3	510.7	10.2	1,106.8	579.3	514.6	12.9

* Excludes short-term creditors as permitted by FRS13.
** Includes issue costs of syndicated loan facility of £1.9m (2004: £2.9m).
\# Represents deposits from retailers. The deposits are repayable when trading ceases and, therefore, there is no fixed term to maturity.

Currency	At 31 March 2005 Fixed rate financial liabilities Weighted average interest rate %	Weighted average period for which rate is fixed Years	Financial liabilities on which no interest is paid Weighted average period until maturity Years	At 31 March 2004 Fixed rate financial liabilities Weighted average interest rate %	Weighted average period for which rate is fixed Years	Financial liabilities on which no interest is paid Weighted average period until maturity Years
Sterling	9.8	3.2	–	9.8	4.2	–
US Dollar	6.4	4.2	–	6.4	4.8	–
Yen	–	–	n/a#	–	–	n/a#
Euro	–	–	–	–	–	–

\# Represents deposits from retailers. The deposits are repayable when trading ceases and, therefore, there is no fixed term to maturity.

Floating rate financial liabilities comprise bank borrowings. All floating rate financial liabilities bear interest at rates fixed by reference to the applicable bank reference rate in the relevant country for periods ranging from overnight to six months.

The figures shown in the tables above take into account various interest rate and currency swaps used to manage interest rate risk and the currency profile of financial liabilities. See Note 17 (viii) for further details of interest rate swaps held as at 31 March 2005.

(ii) Interest rate risk profile of the financial assets of the Group

Currency	At 31 March 2005 Total* £m	Floating rate financial assets £m	Fixed rate financial assets £m	Financial assets on which no interest is earned# £m	At 31 March 2004 Total* £m	Floating rate financial assets £m	Fixed rate financial assets £m	Financial assets on which no interest is earned# £m
Sterling	174.7	113.1	–	61.6	202.3	141.7	–	60.6
US Dollar	41.8	15.3	–	26.5	97.6	59.6	–	38.0
Yen	23.8	20.4	–	3.4	43.7	38.3	–	5.4
Euro	35.3	33.7	–	1.6	57.4	55.0	–	2.4
Swedish Krona	3.7	3.3	–	0.4	2.6	2.1	–	0.5
Danish Krone	1.2	1.1	–	0.1	1.1	1.0	–	0.1
Other	59.9	55.6	–	4.3	48.2	47.5	–	0.7
Total	340.4	242.5	–	97.9	452.9	345.2	–	107.7

* Excludes short-term debtors as permitted by FRS13.
\# Financial assets on which no interest is earned represent mainly advances to artists and investments for which no meaningful average fixed period to maturity can be calculated.

Floating rate financial assets comprise cash at bank and deposits. All floating rate financial assets earn interest at rates fixed in advance by reference to the applicable bank reference rate in the relevant country for periods ranging from overnight to six months.

17. Derivatives and other financial instruments (continued)

(iii) Currency exposures

As explained on page 36 in the Financial review, the Group's objective in managing currency exposures arising from its net investments overseas (its structural currency exposures) is to maintain appropriate levels of borrowings by currency to hedge partially against currency depreciation. Gains and losses arising from these structural currency exposures are recognised in the Statement of total recognised gains and losses.

The table below shows the Group's currency exposures, being those trading assets and liabilities (or non-structural exposures) that give rise to the net currency gains and losses recognised in the Consolidated profit and loss account. Such exposures comprise the monetary assets and monetary liabilities of the Group that are not denominated in the operating (or functional) currency of the operating unit involved, other than certain non-Sterling borrowings treated as hedges of net investments in overseas operations. These exposures were as follows:

At 31 March 2005

			Net foreign currency monetary assets (liabilities)		
Functional currency of Group operation	Sterling £m	US Dollar £m	Yen £m	Euro £m	Other £m
Sterling	n/a	0.2	0.9	10.7	14.2
US Dollar	(0.2)	n/a	0.3	(0.1)	2.3
Yen	(1.3)	(1.9)	n/a	(0.8)	0.3
Euro	0.7	0.4	–	n/a	0.6
Other	(2.2)	0.9	(5.1)	(2.7)	(1.2)
Total	(3.0)	(0.4)	(3.9)	7.1	16.2

At 31 March 2004

			Net foreign currency monetary assets (liabilities)		
Functional currency of Group operation	Sterling £m	US Dollar £m	Yen £m	Euro £m	Other £m
Sterling	n/a	(6.6)	9.1	8.7	15.1
US Dollar	3.5	n/a	–	(0.4)	(0.4)
Yen	(0.5)	(0.2)	n/a	–	0.2
Euro	9.5	(2.8)	(0.1)	n/a	1.4
Other	(3.8)	(0.6)	(5.3)	0.2	–
Total	8.7	(10.2)	3.7	8.5	16.3

(iv) Maturity of financial liabilities

The maturity profile of the Group's financial liabilities, other than short-term creditors such as trade creditors and accruals, was as follows:

	2005 £m	2004 £m
In one year or less, or on demand	30.0	35.8
In more than one year but not more than two years	2.5	3.6
In more than two years but not more than five years	634.5	391.0
In more than five years	415.2	676.4
Total	1,082.2	1,106.8

17. Derivatives and other financial instruments (continued)

(v) Undrawn facilities

The Group has various borrowing facilities available to it. The undrawn committed facilities available at 31 March in respect of which all conditions precedent had been met at that date were as follows:

	2005 £m	2004 £m
Expiring in one year or less	116.4	14.4
Expiring in more than one year but not more than two years	–	–
Expiring in more than two years	236.9	242.8
Total	353.3	257.2

(vi) Fair values of financial assets (liabilities)

	2005 Book value £m	2005 Fair value* £m	2004 Book value £m	2004 Fair value* £m
Primary financial instruments held or issued to finance the Group's operations:				
Short-term borrowings and current portion of long-term borrowings	(13.6)	(13.6)	(35.8)	(35.8)
Long-term borrowings	(1,058.4)	(1,228.2)	(1,058.1)	(1,270.1)
Liquid funds	242.5	242.5	345.2	345.2
Other financial liabilities	(10.2)	(10.2)	(12.9)	(12.9)
Derivative financial instruments held to manage the interest rate and currency profile:				
Interest rate swaps	–	8.3	–	12.6
Interest rate caps and collars	–	–	–	–
Currency swaps and forward foreign currency contracts	–	–	–	–
Financial assets:				
Financial assets – listed investments	3.5	4.3	1.6	2.1
Financial assets – other	94.4	94.4	106.1	106.1

* Market rates have been used to determine fair values.

Long-term borrowings include US$500m 8.375% Guaranteed Notes (book value £263.2m) with a fair value of £286.8m and €425m 8.625% Senior Notes (book value £285.3m) with a fair value of £347.0m. The Group holds equivalent US Dollar and Euro nominal value interest rate swaps matching the coupon on both the US$ Notes and Euro Bond, effectively converting the interest basis to floating rate (set in arrears). At 31 March 2005, these swaps had a fair value of £(10.6)m and £18.9m respectively. Long-term borrowings also include a Sterling Bond issue (book value £322.1m), with a fair value of £349.9m, US$123.75m 6.96% Senior Notes (book value £65.1m) with a fair value of £39.4m and US$243.3m 5.25% guaranteed convertible bond issue (book value £123.5m) with a fair value of £205.9m. The majority of other borrowings and liquid funds are short-term in nature and book values approximate to fair values. For all other financial assets and liabilities, book values approximate to fair values.

(vii) Management of interest rate risk

As explained on page 36 in the Financial review, the Group's policy is to manage interest rate risk, using interest rate swaps, caps and collars. Unrecognised gains and losses on instruments used for managing interest rate risk, and the movements therein, are as follows:

	Gains £m	Losses £m	Total net gains (losses) £m
Unrecognised gains and losses on hedges at 1 April 2004	12.6	–	12.6
Gains and losses arising in previous years that were recognised in 2005	–	–	–
Gains and losses arising before 1 April 2004 that were not recognised in 2005	12.6	–	12.6
Gains and losses arising in 2005 that were not recognised in 2005	9.1	(13.4)	(4.3)
Unrecognised gains and losses on hedges at 31 March 2005	21.7	(13.4)	8.3
Of which:			
Gains and losses expected to be recognised in 2006 or later	–	–	–
Gains and losses expected to be recognised in 2007 or later	21.7	(13.4)	8.3
	21.7	(13.4)	8.3

17. Derivatives and other financial instruments (continued)

(viii) Financial instruments

Interest rate agreements

To manage interest rate risk the Group has entered into certain interest rate swap agreements which, as at 31 March 2005, were as follows:

	Notional principal	Termination date	Fixed rate
Interest rate swaps:			
Euro–receive fixed rate and pay floating rate (set in arrears)	€425m	October 2013	8.63%
US Dollar–receive fixed rate and pay floating rate (set in arrears)	$500m	August 2009	8.38%

In February 2003, following a routine review of derivative positions in the prevailing market conditions, the Group unwound a US$500m interest swap position. The swap effectively switched the 8.375% fixed coupon on the US$ Guaranteed Notes issued in August 1999 to a floating rate of interest. The Group received a cash payment of US$86.2m (£55.6m) on the unwind, representing the present value of the expected cash savings from the swap as determined by the expected differential between US short-term and long-term interest rates, discounted at the prevailing market rate. The gain from the unwind is being amortised over the remaining life of the Notes, thus locking in the future interest cost benefit to be obtained from the swap. The swap unwind reduces the Group's overall interest rate risk.

Exchange rate agreements

As at 31 March 2005, the Group had no currency swaps or forward foreign currency contracts outstanding.

18. Other creditors: amounts falling due within one year

	Group 2005 £m	Group 2004 £m	Company 2005 £m	Company 2004 £m
Trade creditors	205.5	196.7	–	–
Royalties and fees payable	607.7	612.6	–	–
Amounts owed to subsidiary undertakings	–	–	11.4	4.7
Amounts owed to associated undertakings	0.6	0.6	0.6	0.6
Corporate taxation	160.3	159.4	25.3	25.4
Deferred consideration payable*	1.0	81.3	–	–
Other taxes including VAT and social security costs	16.1	18.6	0.2	0.5
Dividends payable	63.1	62.8	63.1	62.8
Other creditors	75.1	71.6	36.4	45.6
Accruals and deferred income	163.3	149.9	11.0	6.9
Total	1,292.7	1,353.5	148.0	146.5

* Deferred consideration payable £0.9m (2004: £69.8m) which is not conditional upon the satisfaction of future performance criteria.

19. Other creditors: amounts falling due after more than one year

	Group 2005 £m	Group 2004 £m	Company 2005 £m	Company 2004 £m
Amounts owed to subsidiary undertakings	–	–	792.6	777.5
Deferred consideration payable*	–	0.2	–	–
Accruals and deferred income	10.2	12.7	–	–
Total	10.2	12.9	792.6	777.5

* Deferred consideration payable includes £nil (2004: £0.2m) which is not conditional upon the satisfaction of future performance criteria.

20. Deferred taxation

	Group £m	Company £m
At 31 March 2004	(13.5)	–
Provided in year	2.8	–
Acquisitions, disposals and transfers	2.7	–
At 31 March 2005	**(8.0)**	**–**

The liabilities (assets) for deferred tax provided were as follows:

	Group 2005 £m	Group 2004 £m	Company 2005 £m	Company 2004 £m
Capital allowances in advance of depreciation	6.0	5.5	–	–
Other timing differences	3.7	0.2	–	–
Total liabilities	9.7	5.7	–	–
Depreciation in advance of capital allowances	(0.4)	(2.5)	–	–
Other timing differences	(17.3)	(16.7)	–	–
Total assets	(17.7)	(19.2)	–	–
Net asset	(8.0)	(13.5)	–	–

Those categories for which no deferred tax is provided are outlined in Accounting policies on page 75.

21. Other provisions for liabilities and charges

Group

	Trading £m	Pensions £m	Disposal and fundamental reorganisation £m	Acquisition and integration £m	Total £m
At 31 March 2004	82.2	31.3	20.3	3.3	137.1
Currency retranslation	0.7	1.5	(0.2)	–	2.0
Provisions utilised	(53.0)	(6.4)	(13.2)	(0.6)	(73.2)
Charged against:					
Operating profit	2.3	5.5	–	–	7.8
Reclassification	0.7	–	1.1	–	1.8
At 31 March 2005	**32.9**	**31.9**	**8.0**	**2.7**	**75.5**

Trading provisions include royalty audit and other trading provisions charged through operating profit before exceptional items. They also include restructuring and reorganisation provisions charged through operating exceptional items (see Note 8(i)). £13.9m of the £32.9m (2004: £63.5m of the £82.2m) are restructuring and reorganisation provisions which will be utilised in the short term.

The majority of the disposal and fundamental reorganisation provision will be utilised in the short term.

The pension provisions arise in overseas companies in respect of state schemes and employees covered by the Group's unfunded schemes.

Company

	Trading £m	Pensions £m	Disposal and fundamental reorganisation £m	Acquisition and integration £m	Total £m
At 31 March 2004	3.1	–	0.4	–	3.5
Provisions utilised	(0.8)	–	(0.4)	–	(1.2)
Charged against operating profit	–	–	–	–	–
At 31 March 2005	**2.3**	**–**	**–**	**–**	**2.3**

22. Share capital and share premium account

Group and Company

	Authorised 2005 £m	Authorised 2004 £m	Allotted, called-up & fully paid 2005 £m	Allotted, called-up & fully paid 2004 £m
Ordinary Shares of 14p each	158.8	158.8	110.6	110.4
B Shares of 114.5p each	479.8	479.8	–	–
Deferred shares of 0.0005p each	17.5	17.5	–	–
	656.1	656.1	110.6	110.4

22. Share capital and share premium account (continued)

(i) Ordinary Shares in issue

	Number	Nominal value £m	Premium £m
At 31 March 2004	788,599,755	110.4	445.8
Shares issued during the year on the exercise of options:			
Executive Schemes	1,074,684	0.2	1.5
Savings-Related Scheme	24,308	–	–
At 31 March 2005	**789,698,747**	**110.6**	**447.3**

As at 31 March 2005, the Company had authority to purchase 78,859,975 of its Ordinary Shares; this authority will expire on 12 October 2005 or at the conclusion of the Annual General Meeting in 2005, whichever is the earlier.

(ii) Share options

Options to subscribe for the Company's Ordinary Shares were outstanding as follows (adjusted for the 1996 demerger and the 1997 share capital reorganisation, where appropriate):

Subscription options

	Executive Share Option Schemes	1994 Savings-Related Share Option Scheme
At 31 March 2004	34,694,566	3,489,600
Granted	6,113,038	513,436
Exercised	(1,074,684)	(24,308)
Lapsed	(3,154,251)	(498,684)
At 31 March 2005	**36,578,669***	**3,480,044**
Option price per 14p share (range)	119.25p – 747p	96p – 442p
Final exercise date*	31 January 2015	28 February 2010

* Of which, options over 26,122,936 shares were granted under the 1995 Executive Share Option Scheme and options over 10,455,733 shares were granted under the 2003 Executive Share Incentive Plan.

Share options for the transfer of the Company's Ordinary Shares were outstanding as follows:

Transfer options

	Executive Share Option Schemes
At 31 March 2004	22,972,678
Granted	1,782,368
Exercised	–
Lapsed	(1,612,178)
At 31 March 2005	**23,142,868****
Option price per 14p share (range)	119.25p – 700p
Final exercise date*	17 June 2014

* Options granted under the 1995 Executive Share Option Scheme are normally exercisable no earlier than three years and no later than ten years following the date of grant and are subject to the achievement of performance requirements that must be met before the options normally become exercisable. Options granted under the 2003 Executive Share Incentive Plan, if subject to a pre-vesting performance requirement, are normally exercisable between three and ten years following the date of grant but only if and to the extent that the pre-vesting target has been satisfied. Options granted with the pre-grant conditions normally become exercisable in no fewer than four annual tranches commencing no earlier than the first anniversary of the grant date. Options granted under the 1994 Savings-Related Share Option Scheme are normally exercisable for a six-month period following completion of savings to either a three-year or a five-year savings contract.

** Of which options over 4,764,491 shares were granted under the 2003 Executive Share Incentive Plan.

(iii) Convertible bond

US$ 243.3m 5.25% Guaranteed Convertible Bonds include options to convert into 78,859,870 14p Ordinary Shares.

(iv) Share premium account

The principal elements that make up the Company's share premium account arose as follows:

Group and Company

	Years arising	£m
Conversions to Ordinary Shares of 7% Convertible Redeemable Second Cumulative Preference Shares 1992/99 of £1 each	1989/90 and 1990/91	56.7
A placing of Ordinary Shares linked to the offer for Thames Television	1990/91	78.0
Issue of Ordinary Shares on exercise of subscription rights of warrants originally attached to 7⅞% bonds due 1992; and	1991/92	67.1
the transfer from other reserves in respect of amounts paid for the warrants exercised	1991/92	10.2
Issue of Ordinary Shares on conversion of Convertible Unsecured Loan Stock to fund the acquisition of Virgin Music Group	1992/93	508.4
Issue of Ordinary Shares on conversion of 5¾% Guaranteed Redeemable Preference Shares 2004 of THORN EMI Capital NV	1993/94	126.0
Share capital reorganisation (including issue of Redeemable Preference B Shares)	1997/98	(501.2)
Other issues of Ordinary Shares		102.1
Balance at 31 March 2005		**447.3**

23. Reserves

	Group			Company		
	Capital redemption reserve £m	Other reserves £m	Profit and loss reserve £m	Capital redemption reserve £m	Other reserves £m	Profit and loss reserve £m
At 31 March 2004	495.8	255.7	(2,091.7)	495.8	402.1	1,706.8
Currency translation	–	–	(7.2)	–	–	–
Profit attributable to members of the Holding Company	–	–	56.3	–	–	69.2
Equity dividend	–	–	(63.2)	–	–	(63.2)
Revaluation movements*	–	(0.7)	–	–	–	–
Goodwill adjustments relating to subsidaries	–	–	(0.3)	–	–	–
Transfer between reserves	–	(4.2)	4.2	–	–	–
Purchase of shares by ESOP	–	(0.3)	–	–	(0.3)	–
ESOP charge for year	–	–	2.3	–	–	2.3
ESOP reserve movements	–	1.7	(1.7)	–	1.7	(1.7)
Transfer of realised reserves	–	–	–	–	(2.7)	2.7
At 31 March 2005	**495.8**	**252.2**	**(2,101.3)**	**495.8**	**400.8**	**1,716.1**

* Revaluation movements include £(0.7)m in respect of tangible fixed assets, taking into account the proportion attributable to minority shareholders.

In accordance with the exemption permitted by S230(3) of the Companies Act 1985, the profit and loss account of the Company is not separately presented. The profit attributable to shareholders, dealt with in the accounts of the Company, is £69.2m (2004: £94.4m).

Group reserves include £(9.4)m (2004: £(10.5)m) in respect of its share of post-acquisition retained losses of joint ventures and associated undertakings.

(i) Capital redemption reserve
The capital redemption reserve represents the reduction in distributable reserves for the amount paid to redeem preference B shares as part of the share capital reorganisation.

(ii) Other reserves
Other reserves of the Company contain a special reserve which reflects the share premium account reduction of July 1988 and unrealised profit on disposal of investments.

The EMI Group General Employee Benefit Trust (EBT) was established to hedge the future obligations of the Group in respect of shares awarded under the Senior Executive Incentive Plans. The Trustee of the EBT, EMI Group EBT (Guernsey) Ltd, purchases the Company's Ordinary Shares in the market with financing provided by the Company, as required, on the basis of regular reviews of the anticipated share liabilities of the Group. The EBT has, since December 1998, waived any entitlement to the receipt of dividends in respect of all its holding of the Company's Ordinary Shares. The EBT's waivers may be revoked or varied at any time.

EBT Group and Company

	Shares held in trust No.	Nominal value £m	Cost £m
At 31 March 2004	4,082,771	0.6	18.0
Shares purchased	142,721	–	0.3
Shares vested	(384,977)	(0.1)	(1.7)
At 31 March 2005	**3,840,515**	**0.5**	**16.6**

At 31 March 2005, the outstanding loan by the Company to the EBT to finance the purchase of Ordinary Shares was £16.9m (2004: £18.3m). The market value at 31 March 2005 of the Ordinary Shares held in the EBT, which are listed in the UK, was £9.1m (2004: £11.3m). All shares held in the EBT are either under option to employees or conditionally gifted to them.

(iii) Profit and loss reserve
The Group profit and loss reserve includes £1,265.6m (2004: £1,265.3m) in respect of goodwill previously written off.

24. Minority interests (equity)

Group

	2005 £m	2004 £m
Toshiba-EMI Ltd (Japan)	44.3	63.5
Other	4.0	4.1
Total	48.3	67.6

25. Financial commitments

Group

	2005 £m	2004 £m
Capital expenditure: Contracted	–	–

The Group has commitments, which are largely performance-related, to pay advances to artists and repertoire owners amounting to £388.4m at 31 March 2005 (2004: £382.9m).

Pursuant to a joint venture agreement with Mr Norman Cheng ('Project Typhoon'), the Group has agreed to establish and fund new businesses in the People's Republic of China, Hong Kong and South Korea. The Group has an option to buy, and Mr Cheng has an option to sell to the Group, his equity interest in the joint venture in 2009 at a price determined by reference to earnings over a three-year period. The Group can limit the price it pays to not more than US$100m.

Annual commitments under operating leases at 31 March were as follows:

	Group 2005 £m	Group 2004 £m	Company 2005 £m	Company 2004 £m
Land and buildings:				
Expiring in the first year	3.9	4.1	–	–
Expiring in the second to fifth years inclusive	6.6	7.3	–	–
Expiring after the fifth year	14.0	17.5	3.2	3.2
Total	24.5	28.9	3.2	3.2
Plant, equipment and vehicles:				
Expiring in the first year	0.8	1.0	–	–
Expiring in the second to fifth years inclusive	2.2	2.2	0.1	0.1
Expiring after the fifth year	0.8	–	–	–
Total	3.8	3.2	0.1	0.1

26. Contingent liabilities

The Group, along with other companies in the music and broadcast industries, has received requests from the New York State Attorney General for information regarding practices in connection with the promotion of records on New York state radio stations. The Group is co-operating fully with this inquiry. EMI has a long-standing, strict written policy prohibiting unlawful radio promotion practices, and that policy was reaffirmed internally in early 2004. The inquiry is ongoing and, while it is not possible to be certain as to the eventual outcome, EMI is not currently aware of any reason for believing that there will be a material financial impact on the Group. There are no other significant legal or arbitration proceedings, pending or threatened, against any member of the Group which, so far as the Directors are aware, are likely to result in a liability materially in excess of provisions in the financial statements.

Guarantees and other contingent liabilities total £33.3m (2004: £40.0m). Such liabilities relating to HMV Group plc total £20.7m (2004: £22.1m) and for the former Thorn rental business amount to £3.7m (2004: £9.4m); those in respect of Group companies total £8.9m (2004: £8.5m).

Following the demerger of the Thorn rental business in 1996, Group companies remained contingently liable in respect of guarantees given with regard to certain leases on properties occupied or previously occupied by the Thorn business though, as part of the demerger arrangements, Thorn Limited (formerly called Thorn plc) agreed to indemnify the Group against such liabilities. One of the Group companies so liable was sold to HMV Group plc as part of the 1998 sale and the Company agreed to indemnify HMV Group plc against any such liabilities. The current or former Thorn properties in respect of which the Group remained contingently liable number approximately 50 and the annual rental payments in respect of such properties total approximately £3.6m. Following the insolvency of Thorn High Street Properties Limited and certain other companies, claims have arisen against the Group in respect of many of the guaranteed leases. Such claims have been met by Thorn Limited pursuant to its agreement to indemnify the Group.

As part of the sale in 1998 to HMV Group plc (HMV Group) of the companies and assets comprising HMV, the Group entered into an indemnity deed with HMV Group relating, among other things, to guarantees given by the Group in respect of property leases of which approximately 75 (2004: 79) remain outstanding. Under the deed, HMV Group agreed to indemnify the Group against any payments made under those property leases and certain other guarantees and indemnities. The aggregate annual rental payments under guaranteed leases are approximately £20.7m (2004: £22.1m), although they are subject to adjustment both up and down under certain circumstances. The guaranteed leases have terms which expire in 10 to 21 years (2004: 22 years) and 17 of the leases expire in years beyond 2015. The indemnity deed remains in force in respect of lease guarantees, and HMV Group has secured those obligations pursuant to a security deed, the Company's rights under which rank second behind banks which provide senior credit facilities to HMV Group.

27. Pension arrangements

The Group operates a number of pension schemes throughout the world. The main scheme, which covers employees in the UK, is the EMI Group Pension Fund (the UK Fund). The UK Fund is of the defined benefit type and is open to all permanent employees over the age of 18 employed by the Company and certain subsidiaries in the UK. Benefits provided by the UK Fund are based on final pensionable pay. Pensions payable from the UK Fund are guaranteed to increase by 5% per annum or, if a lower rate, by the increase in the cost of living. Members contribute to the UK Fund at the rate of 4% of pensionable pay. With effect from 1 April 2004, the Company has contributed a further 21% of pensionable pay.

Aside from the UK, the Group has significant defined benefit schemes in Germany and Japan. With the exception of these schemes, the other defined benefit schemes operated on behalf of the Group are not material. With the exception of the UK fund, the currently agreed rates of contribution by the Group are nil for all significant defined benefit schemes.

Staff engaged in other countries are covered by local arrangements which, in the case of the Group schemes, are of the defined contribution type. The assets of the Group's pension schemes are held mainly in separate trustee-administered funds.

Employer contributions of £10.8m (2004: £12.6m) were charged to the Profit and loss account in the year. Other post-retirement benefit expenses of £0.1m (2004: £0.2m) were also charged to the Profit and loss account.

Provision is made in the financial statements for the benefits accruing to members of unfunded pension schemes in accordance with the advice of independent actuaries.

The latest available actuarial valuation of the UK Fund was made by a qualified actuary as at 31 March 2003 using the projected unit method. At that date and on the prudent funding basis used by the Trustee, the market value of the assets was sufficient to cover 91% of the value of the benefits that have accrued to the members, after allowing for assumed increases in earnings, on the actuarial assumptions used, treating the UK Fund as an ongoing entity.

Employer expense in respect of the UK Fund has been calculated in accordance with SSAP24. On the basis of actuarial advice and using a realistic basis for SSAP24 purposes which resulted in the market value of assets being sufficient to cover 109% of the value of the benefits, it is calculated that the profit and loss charge for the year ended 31 March 2005 is £nil (2004: £nil).

For SSAP24 purposes we have used the following assumptions:

	% per annum
Rate of investment return	6.80
Rate of pay increases	4.75
Rate of pension increases	2.75
Rate of price inflation	2.75

The most recent full actuarial valuations of the three significant defined benefit schemes were carried out as follows: UK on 31 March 2003, Germany on 1 April 2003 and Japan on 31 October 2003.

The additional disclosures required by FRS17 are set out below.

The most recent full actuarial valuations have been updated to 31 March 2005 by qualified independent actuaries.

	United Kingdom			Germany			Japan		
	2005 %	2004 %	2003 %	2005 %	2004 %	2003 %	2005 %	2004 %	2003 %
Major assumptions									
Rate of general increase in salaries	4.75	4.75	4.25	3.50	3.50	3.50	2.0-3.7	2.0-3.7	2.4-5.0
Rate of increase to pensions in payment	2.75	2.75	2.25	2.00	2.00	2.00	Nil	Nil	Nil
Rate of increase to deferred pensions	2.75	2.75	2.25	2.00	2.00	2.00	Nil	Nil	Nil
Discount rate for scheme liabilities	5.40	5.50	5.50	4.50	4.75	5.00	2.00	2.00	1.25
Inflation	2.75	2.75	2.25	2.00	2.00	2.00	Nil	Nil	Nil

27. Pension arrangements (continued)

On full compliance with FRS17, on the basis of the above assumptions, the amounts that would have been charged to the Consolidated profit and loss account and Statement of total recognised gains and losses for the year ended 31 March 2005 are set out below:

	United Kingdom 2005 £m	United Kingdom 2004 £m	Germany 2005 £m	Germany 2004 £m	Japan 2005 £m	Japan 2004 £m
Operating profit						
Current service cost	9.0	7.0	0.3	0.3	2.2	2.4
Past service cost	–	–	–	–	–	–
Gain on settlements	–	(4.0)	–	–	–	–
Gain on curtailment	–	–	–	–	–	–
Total charge (credit) to operating profit	9.0	3.0	0.3	0.3	2.2	2.4
Finance income						
Expected return on scheme assets	(54.0)	(47.0)	–	–	(1.1)	(0.8)
Interest on scheme liabilities	45.0	43.0	1.5	1.5	1.0	0.7
Net (credit) charge to finance income	(9.0)	(4.0)	1.5	1.5	(0.1)	(0.1)
Total (credit) charge to profit and loss account before taxation	–	(1.0)	1.8	1.8	2.1	2.3
Statement of total recognised gains and losses						
Actual return less expected return on scheme assets	(32.0)	(109.0)	–	–	0.7	1.3
Experience (gains) and losses arising on the scheme liabilities	16.0	(27.0)	(1.2)	–	(3.2)	(2.0)
Changes in assumptions underlying the present value of the scheme liabilities	12.0	86.0	1.3	1.2	–	(3.9)
Actuarial (gains) and losses recognisable in the Statement of total recognised gains and losses	(4.0)	(50.0)	0.1	1.2	(2.5)	(4.6)

	United Kingdom 2005 %	United Kingdom 2004 %	Germany 2005 %	Germany 2004 %	Japan 2005 %	Japan 2004 %
Further disclosures						
Difference between the expected and actual return on scheme assets expressed as a percentage of the scheme assets	3.9	13.9	–	–	0-(1.7)	0-(2.9)
Experience gains and (losses) on scheme liabilities expressed as a percentage of the present value of the scheme liabilities	(1.8)	3.2	3.8	–	10.0-(4.1)	9.5-(79.7)
Total actuarial gains and (losses) recognised in the Statement of total recognised gains and losses, expressed as a percentage of the present value of the scheme liabilities	0.5	5.9	(0.3)	(3.7)	10.0-(4.1)	80.3-(4.3)

The market values of the assets of the three significant defined benefit schemes at 31 March 2005 were as follows:

	United Kingdom 2005 £m	United Kingdom 2004 £m	United Kingdom 2003 £m	Germany 2005 £m	Germany 2004 £m	Germany 2003 £m	Japan 2005 £m	Japan 2004 £m	Japan 2003 £m
Market value of assets*									
Equities	484.0	541.0	432.0	–	–	–	–	–	–
Bonds	329.0	235.0	252.0	–	–	–	–	–	–
Other	17.0	9.0	13.0	0.5	0.7	1.0	42.1	44.4	44.5
Total market value of assets	830.0	785.0	697.0	0.5	0.7	1.0	42.1	44.4	44.5
Present value of scheme liabilities	(885.0)	(850.0)	(813.0)	(32.8)	(31.4)	(31.1)	(46.0)	(52.5)	(59.0)
Deficit in the scheme	(55.0)	(65.0)	(116.0)	(32.3)	(30.7)	(30.1)	(3.9)	(8.1)	(14.5)
Pension liability before deferred tax	(55.0)	(65.0)	(116.0)	(32.3)	(30.7)	(30.1)	(3.9)	(8.1)	(14.5)
Deferred tax	16.5	19.5	34.8	10.6	11.7	11.4	1.6	3.4	6.1
Amount provided to cover scheme deficit	n/a	n/a	n/a	32.3	30.4	30.7	n/a	(4.1)	(2.4)
Impact on reserves	(38.5)	(45.5)	(81.2)	10.6	11.4	12.0	(2.3)	(8.8)	(10.8)

* The expected long-term rate of return on the assets is as follows:

United Kingdom	6.7% (equities 8.0%, bonds 4.8%, other 3.8%) (2004: 7.0% (equities 8.1%, bonds 4.9%, other 3.8%), 2003: 7.0% (equities 8.4%, bonds 4.8%, other 3.8%))
Germany	4.0% (2004: 4.5%, 2003: 4.5%)
Japan	2.5% (2004: 2.5%, 2003: 1.75%)

27. Pension arrangements (continued)

Movement in surplus (deficit) during year:

	United Kingdom		Germany		Japan	
	2005 £m	2004 £m	2005 £m	2004 £m	2005 £m	2004 £m
(Deficit) surplus in scheme at beginning of year	(65.0)	(116.0)	(30.7)	(30.1)	(8.1)	(14.6)
Exchange adjustments	–	–	(1.1)	1.1	0.4	0.3
Current service cost	(9.0)	(7.0)	(0.3)	(0.3)	(2.2)	(2.4)
Past service cost	–	–	–	–	–	–
Gain on settlement	–	4.0	–	–	–	–
Gain on curtailment	–	–	–	–	–	–
Cash contributions	6.0	–	1.3	1.3	3.4	3.9
Other finance income (expense)	9.0	4.0	(1.5)	(1.5)	0.1	0.1
Actuarial gain (loss)	4.0	50.0	–	(1.2)	2.5	4.6
(Deficit) in scheme at end of year	(55.0)	(65.0)	(32.3)	(30.7)	(3.9)	(8.1)

28. Related party transactions

The Company has taken advantage of the exemption under FRS 8 – *Related Party Disclosures* not to disclose related party transactions between Group subsidiary undertakings. The Group had no material transactions with any other related parties during the year.

Five year summary

	2005 £m	2004 £m	2003 Restated £m	2002 Restated £m	2001 Restated £m
Results					
Turnover:					
Continuing operations	1,942.8	2,120.7	2,175.4	2,445.8	2,672.7
Operating profit:					
Continuing operations					
Group operating profit before exceptional items and amortisation	232.9	249.3	254.7	190.9	332.5
Share of joint venture operating profit (HMV Group plc – discontinued)	–	–	0.4	34.3	34.4
Share of associated undertakings' operating (losses) profits	1.1	(0.3)	0.2	(1.1)	(3.8)
Total operating profit before exceptional items and amortisation	234.0	249.0	255.3	224.1	363.1
Operating exceptional items	–	(138.3)	(21.1)	(242.4)	(42.9)
Amortisation of goodwill and music copyrights	(50.9)	(50.9)	(42.8)	(51.3)	(53.8)
	183.1	59.8	191.4	(69.6)	266.4
Non-operating exceptional items:					
(Losses) on businesses disposed of or terminated	–	(40.4)	(25.2)	–	–
Profits on disposal of fixed assets and investments	0.8	23.9	234.9	–	–
Profit (loss) before finance charges	183.9	43.3	401.1	(69.6)	266.4
Finance charges	(92.1)	(96.1)	(77.3)	(83.2)	(103.6)
(Loss) profit before taxation	91.8	(52.8)	323.8	(152.8)	162.8
Taxation	(31.2)	(19.7)	(83.2)	(38.2)	(70.9)
(Loss) profit after taxation	60.6	(72.5)	240.6	(191.0)	91.9
Minority interests	(4.3)	0.9	(6.4)	(8.5)	(12.7)
(Loss) profit attributable to members of the Holding Company	56.3	(71.6)	234.2	(199.5)	79.2
Operating assets					
Music copyrights	402.8	448.7	451.2	518.2	546.8
Goodwill	33.2	31.8	56.2	34.0	61.1
Property, plant, equipment and vehicles	183.1	202.7	289.4	277.3	306.8
Fixed asset investments	22.9	19.3	22.2	29.5	48.6
Stock and debtors, excluding taxation and interest	782.7	797.0	973.9	919.6	994.9
Creditors and provisions, excluding taxation, dividends and interest payable	(1,086.8)	(1,201.5)	(1,210.4)	(1,296.4)	(1,231.3)
Investment in HMV Group plc	–	–	–	(159.9)	(168.3)
Operating assets	337.9	298.0	582.5	322.3	558.6
Key statistics					
Net borrowings	829.5	748.7	859.8	1,057.9	992.8
Net cash inflow from operating activities	221.4	309.4	117.2	211.9	314.8
Capital expenditure:					
Fixed assets (continuing operations)	29.9	51.3	68.5	39.2	42.8
Earnings per Ordinary Share:					
Basic	7.2p	(9.1)p	29.3p	(25.5)p	10.1p
Adjusted diluted	13.0p	15.5p	15.7p	11.8p	21.9p
Dividends per Ordinary Share	8.0p	8.0p	8.0p	8.0p	16.0p
Return on sales	12.0%	11.8%	11.7%	7.8%	12.4%
Effective tax rate (before exceptional items and amortisation)	22.0%	19.9%	25.3%	30.0%	27.3%
Interest cover – excluding joint venture (HMV Group plc – discontinued)	3.0x	3.3x	3.9x	4.0x	5.2x
Dividend cover	1.6x	1.9x	2.0x	1.5x	1.4x

Since 1 April 2000, several new accounting standards have been adopted (FRS17 to FRS19, UITF17 (Revised) and UITF38) and, where appropriate, comparative results have been restated to reflect the resulting changes in accounting policies and presentation of information.

Investor information

Financial calendar
Results announcements
Interim to 30 September 2005: 16 November 2005*
Final to 31 March 2006: 23 May 2006*

AGMs and Reports
2005 Annual General Meeting: 14 July 2005
2005 Interim Report: 25 November 2005*
2006 Annual Report: 9 June 2006*
2006 Annual General Meeting: 13 July 2006*

Dividend payment dates
2005 final: payable on 7 October 2005 to shareholders on the register of members at the close of business on 9 September 2005
2006 interim: payable on 3 April 2006* to shareholders on the register of members at the close of business on 10 March 2006*

* Proposed dates

Lloyds TSB Registrars
Questions about shareholdings, or changes of address or any other particulars, should be sent to: *Lloyds TSB Registrars, Shareholder Services, The Causeway, Worthing, West Sussex BN99 6DA, UK.* A helpline, available at local call rates in the UK only, operates during normal office hours on *0870 600 3984*. Shareholders outside the UK should call *+44 121 415 7060*.

www.shareview.co.uk
Lloyds TSB Registrars have a website at: *www.shareview.co.uk* where shareholders can view information about their shareholdings, as well as find information on how to register a change of name and what to do if a share certificate is lost. There are also facilities to download change of address, dividend mandate and stock transfer forms.

Multiple accounts
If shareholders receive multiple copies of the Group's Annual or Interim Reports, due to differing name and address details, they should write to Lloyds TSB Registrars requesting that their accounts be amalgamated.

Payment of dividends to UK bank or building society accounts
Shareholders who wish to have their dividends paid directly into their UK bank or building society account should request a dividend mandate form from Lloyds TSB Registrars or download the form from *www.shareview.co.uk*. An annual tax voucher will be sent to the shareholder's registered address at the time of the interim dividend payment in March or April each year. The voucher will list all of the dividends paid during the tax year. A tax voucher in respect of the final dividend paid on 1 October 2004 and the interim dividend paid on 1 April 2005 was sent to shareholders in April 2005.

Payment of dividends to overseas shareholders
Arrangements can be made for shareholders in a range of countries outside the UK to have their dividends paid directly into their bank account in their local currency. To find out if such a service can be made available to you, please contact Lloyds TSB Registrars on *+44 121 415 7060*.

Share dealing service #
A telephone and internet dealing service has been arranged through Lloyds TSB Registrars which provides a simple way for UK-resident shareholders to buy or sell EMI Group plc shares. Commission is 0.5% with a minimum charge of £20 for telephone dealing and £17.50 for internet dealing. For telephone dealing call *0870 850 0852* between 8.30am and 4.30pm, Monday to Friday, and for internet dealing log on to *www.shareview.co.uk/dealing*. You will need your shareholder reference number shown on your share certificate.

ShareGift
If you have a small number of EMI Group plc shares, with a value that makes it uneconomic to sell them, you may donate the shares to charity through the ShareGift scheme operated by The Orr Mackintosh Foundation (registered charity 1052686). Further information on ShareGift can be obtained from their website at *www.sharegift.org* or by calling *020 7337 0501*.

Individual Savings Accounts (ISA) #
Lloyds TSB Bank plc can provide a single company ISA for EMI Group plc Ordinary Shares. Details of this ISA, which is only available to UK-resident shareholders, may be obtained from Lloyds TSB Registrars by writing to them at: *The Causeway, Worthing, West Sussex BN99 6UY*, or by calling their ISA helpline on *0870 24 24 244*.

Monthly Purchase Plan (MPP) #
Lloyds TSB Bank plc provides an MPP for EMI Group plc Ordinary Shares. Information about this MPP may be obtained by writing to: *The Administrators – Monthly Purchase Plans, Lloyds TSB Registrars, The Causeway, Worthing, West Sussex BN99 6DA, UK*, or by calling their MPP helpline on *0870 60 60 268*.

American Depositary Receipts (ADRs)
The Company's ADRs trade on the Over-the-Counter market, with one American Depositary Share (ADS) representing two EMI Group plc Ordinary Shares. JPMorgan Chase Bank, N.A. is the Depositary for the Company's ADSs. Enquiries should be directed to: *JPMorgan Service Center, PO Box 43013, Providence, RI 02940-3013, USA*; Tel: *1-800 428 4237* (toll-free in the USA) or *1-781 575 4328*; Website: *www.adr.com*

£/US$ dividend conversion facility
This service enables the holders of Ordinary Shares who are resident in the US to receive their dividends in US Dollars rather than Sterling. Details of this facility may be obtained from: *DB Services Tennessee, Inc., PO Box 305050, Nashville, Tennessee 37230, USA*; Tel: *1-615 835 3100*.

UK capital gains tax information
The market value of the Ordinary Shares of EMI Group plc (then known as THORN EMI plc) held on 31 March 1982, as adjusted for subsequent capitalisation issues, was 408.15p per share.

The base cost of EMI Group plc Ordinary Shares acquired prior to the demerger of 19 August 1996 will need to be apportioned between EMI Group plc Ordinary Shares of 25p each and Thorn plc Ordinary Shares of 25p each in the proportion 78.8% to 21.2%.

The base cost of EMI Group plc Ordinary Shares of 25p each held prior to the share capital reorganisation of 21 July 1997 will then need to be apportioned between the new Ordinary Shares of 14p each and the former B Shares of 114.5p each in the proportion 89.4% to 10.6%.

Share price information
The market price of EMI Group plc's Ordinary Shares is available from the EMI Group website at the address shown under Website/general enquiries below. Within the UK, this price is also available on Ceefax and Teletext, or by calling the FT Cityline service on *0906 843 4214* or *0906 003 4214* (calls charged at 60p per minute).

Unsolicited mail
By law, the EMI Group plc share register has to be available for public viewing. If you wish to avoid receiving unsolicited mail from other organisations, please write to: *Mailing Preference Service, Freepost 22, London W1E 7EZ*, or call *08457 034599* for an application form. You can also register online at: *www.mpsonline.org.uk*

Annual and Interim Reports
Copies of the Group's previous Annual and Interim Reports are available from the Corporate Communications Department at the address shown below in italics or, for 1997 onwards, on the EMI Group website at the address shown under Website/general enquiries below.

Social Responsibility Report and information
The Group's Social Responsibility Report for 2004 is available on the EMI Group website at the address shown under Website/general enquiries below. The printed version and further information on social responsibility matters may be obtained from the Corporate Communications Department at the address shown below in italics.

Website/general enquiries
The EMI Group website provides news and financial information about the Group, as well as its music and music publishing businesses, together with links to its music labels.

General enquiries may be addressed to the Corporate Communications Department at: *EMI Group plc, 27 Wrights Lane, London W8 5SW, UK*; Tel: *020 7795 7000*. Callers from outside the UK should call: *+44 20 7795 7000*. Website: *www.emigroup.com*

The publication of the information in respect of the share dealing service, Individual Savings Accounts and the Monthly Purchase Plan has been approved, for the purposes of section 21(2)(b) of the Financial Services and Markets Act 2000, by Lloyds TSB Bank plc, part of the Lloyds TSB Group, which is regulated by the Financial Services Authority.

Analysis of Ordinary Shareholdings at 20 May 2005

Range	No. of holdings	%	Balance as at 20 May 2005	%
1 to 500	10,288	48.88	2,097,678	0.27
501 to 1,000	4,689	22.28	3,449,325	0.44
1,001 to 10,000	5,152	24.48	12,204,542	1.54
10,001 to 100,000	476	2.26	16,859,909	2.13
100,001 to 1,000,000	316	1.50	113,772,488	14.41
1,000,001 and over	126	0.60	641,320,095	81.21
Totals	21,047	100.00	789,704,037	100.00

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Design
SEA

Print
The Colourhouse

Board Photography
Harry Borden

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EXHIBIT CO 0730

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-K

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

For the fiscal year ended December 31, 2005

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 0-28018

YAHOO! INC.

(Exact name of Registrant as specified in its charter)

Delaware	77-0398689
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

701 First Avenue
Sunnyvale, California 94089
(Address of principal executive offices)

Registrant's telephone number, including area code: (408) 349-3300

Securities registered pursuant to Section 12(b) of the Act:
None

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

Common stock, $.001 par value
(Title of Class)

Indicate by check mark if the Registrant is a well-known seasoned issuer as defined in Rule 405 of the Securities Act. Yes ☒ No ☐

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

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

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

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer ☒ Accelerated filer ☐ Non-accelerated filer ☐

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

As of June 30, 2005, the aggregate market value of voting stock held by non-affiliates of the Registrant, based upon the closing sales price for the Registrant's common stock, as reported in the NASDAQ National Market System was $43,726,484,063. Shares of common stock held by each officer and director and by each person who owns 10 percent or more of the outstanding common stock have been excluded in that such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for any other purpose.

The number of shares of the Registrant's common stock outstanding as of February 28, 2006 was 1,417,852,971.

DOCUMENTS INCORPORATED BY REFERENCE

The following documents (or parts thereof) are incorporated by reference into the following parts of this Form 10-K:

(1) Proxy Statement for the 2006 Annual Meeting of Stockholders — Part III Items 10, 11, 12, 13 and 14.

YAHOO! INC.
Form 10-K
Fiscal Year Ended December 31, 2005

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The trademarks and/or registered trademarks of Yahoo! Inc. and its subsidiaries referred to herein include Yahoo!, Yahoo! Go, My Yahoo!, del.icio.us, Flickr, Farechase, HotJobs, Inktomi, Kelkoo, Musicmatch, Overture and Yahooligans. All other names are trademarks and/or registered trademarks of their respective owners.

Part I

Item 1. Business

OVERVIEW

Yahoo! Inc., together with its consolidated subsidiaries ("Yahoo!", the "Company", "our", "we", or "us"), is a leading global Internet brand and one of the most trafficked Internet destinations worldwide. We seek to provide Internet services that are essential and relevant to users and businesses. To users, we provide our owned and operated online properties and services (the "Yahoo! Properties"). To businesses, we provide a range of tools and marketing solutions designed to enable businesses to reach our community of users. Yahoo! was developed and first made available in 1994 by our founders, David Filo and Jerry Yang, while they were graduate students at Stanford University. We were incorporated in 1995 and are a Delaware corporation. We are headquartered in Sunnyvale, California, and have offices in Asia, Australia, Canada, Europe, Latin America, and the United States.

We seek to leverage the power of the Yahoo! Properties to create the most innovative and highest quality Internet services for users and to provide the most efficient and effective marketing services for businesses to reach these users. We focus on increasing our user base and deepening the engagement of our users on the Yahoo! Properties to enhance the value of our user base to advertisers and to increase the spending of these advertisers. We believe that we can increase our user base by offering compelling Internet services and effectively integrating search, community, personalization, and content to create a powerful user experience. These global user relationships and the social community created enable us to leverage our offered forms of online advertising as well as premium services for users.

We also focus on extending our marketing platform and access to Internet users beyond the Yahoo! Properties through our distribution network of third party entities (which we refer to as "affiliates") who have integrated our search offerings into their websites.

Many of our services are free to our users. We generate revenue by providing marketing services to businesses across the majority of our properties and by establishing paying relationships with our users for premium services. We classify these revenues as either marketing services or fees. Our offerings to users and businesses currently fall into four categories — Search; Marketplace; Information and Entertainment; and Communications and Connected Life. The majority of our offerings are available globally in more than 15 languages.

2005 HIGHLIGHTS

During 2005, our key accomplishments that we believe will allow us to further our mission to provide Internet services that are essential and relevant to users and businesses include:

Strengthened our international presence:

- China — We entered into a strategic partnership with Alibaba.com Corporation ("Alibaba"), a large e-commerce company in China operating a leading online marketplace and an online payment system. The combination of our China based businesses with Alibaba has created one of the largest Internet companies in China that we believe is well positioned to provide services to China's local emerging and fast growing Internet market.
- Europe and Korea — We acquired the remaining shares of our joint ventures in France, Germany and the United Kingdom (collectively "Yahoo! Europe") and Yahoo! Korea, bringing our ownership in these entities to 100 percent. Full ownership of the Yahoo! Properties in Europe and Korea provides us with greater flexibility to take advantage of international growth opportunities in the Internet market in these regions.

- Australia — We signed an agreement with Seven Networks Limited ("Seven"), a leading media company in Australia, to combine our Australian Internet business with their rich media and entertainment content to create what we believe will be one of the most comprehensive and engaging online experiences for local users and advertisers. We completed this transaction in January 2006.

Introduced social community tools and expanded our offerings and content on Yahoo! Properties:

- Introduced Yahoo! 360° — a new innovative service allowing users to communicate and connect with friends and family while integrating several Yahoo! offerings.
- Acquired Flickr — a popular website offering photo management and photo sharing.
- Acquired del.icio.us — a free website offering social bookmarking services.
- Launched Yahoo! Answers — a free platform that allows users to ask and answer questions on any topic in an easy-to-use environment.
- Launched the next generation Yahoo! Messenger — with free PC-to-PC calling, interactive photo-sharing and greater community facilitation.
- Launched Yahoo! Music Unlimited — a music subscription service providing users with control of their music experience and access to unique personalization and community features.
- Enhanced Yahoo! Mail — providing users with a faster experience, increased functionality, and improved user interface.
- Introduced exclusive content — from respected columnists on Yahoo! Finance property and two exclusive features on Yahoo! News — *Kevin Sites in the Hot Zone* and *Richard Bangs Adventures*.

Established new alliances with industry partners:

- Entered into new and extended existing broadband alliances to offer co-branded broadband services with dominant communication companies across the United States and internationally.
- Entered into an interoperability agreement with Microsoft Corporation to connect users of Yahoo! Messenger and MSN Messenger.

Since inception we have made a number of strategic acquisitions including business combinations, asset acquisitions and investments. We expect to continue to acquire or make investments in companies, products, services and technologies in the future. See Note 3 — "Acquisitions" of the Notes to the Consolidated Financial Statements, which appears in Item 8 of this Annual Report on Form 10-K for additional information related to our acquisitions.

Our accomplishments are possible because of our dedicated, highly skilled and talented employees. We believe that Yahoo! attracts among the most highly qualified and accomplished scientists, engineers, design specialists, marketers and professionals. We seek to recruit and retain people who thrive on the opportunity Yahoo! provides to solve some of the most technically challenging problems benefiting hundreds of millions of users across a range of areas, such as search, communications, media, mobility, community, data and advertising.

MARKETING SERVICES FOR BUSINESSES

As part of our strategy to provide the most efficient and effective marketing services for businesses, we are committed to providing a comprehensive set of Internet marketing solutions for advertisers. There is ongoing growth in the advertising market and an increasing shift in advertisers' use of online media as

audiences shift toward the Internet from traditional media. We are committed to capitalizing on this shift and helping our advertisers create and execute Internet marketing solutions that both engage users to interact with our advertisers' brands as well as provide valuable insights into their customer base. We utilize our continuing research of the marketplace and our understanding of our users and their interests to offer a suite of targeted marketing services for our advertisers to meet the full range of their needs from brand building, to consumer awareness, direct marketing, lead generation and commerce services. Our offerings enable marketers to display their advertisements in different formats and in different locations on the Yahoo! Properties and our affiliates' websites.

Advertisers can display graphical advertisements across the Yahoo! Properties on the pages that are viewed by our users. Yahoo! offers a broad range of tools available for online display advertising, including rich media, video and targeting. We work with our advertisers to maximize the effectiveness of their campaigns by optimizing advertisement formats and placement on the network. We also use our targeting capabilities to help advertisers reach their desired audiences by placing contextually relevant advertisements on our pages. For these advertising services, we earn revenue as "impressions" are delivered. An "impression" is delivered when an advertisement appears in pages viewed by users.

Advertising is also provided through a series of search offerings that enable advertisers to display text based links to their websites on the Yahoo! Properties as well as on our affiliates' websites. These advertisements are displayed in response to different user actions — when a keyword is used in a search query initiated by a user or when specific content is being viewed by a user on the Yahoo! Properties or on the networks of our affiliates. For example, if a user searches using the keyword "television" in the Yahoo! Search box or the search box on the website of one of our affiliates, links to websites for advertisers selling televisions will appear alongside the algorithmic search results. As another example, if the user is reading an article about interest rates, he or she may be presented with advertising links to websites for mortgage-related advertisers. For these advertising services, we earn revenue when "click-throughs" occur. A "click-through" occurs when a user clicks on an advertiser's listing. Such advertising services will be referred to as "search marketing."

We also provide services that allow businesses to list information on the Yahoo! Properties, which can be accessed by our users. For example, a company can include job postings on our Yahoo! HotJobs site or include information about its business in our Yahoo! Local Enhanced Listing Service. We earn revenues as these listing services are provided.

OFFERINGS TO USERS

Our offerings to users on our Yahoo! Properties currently fall into four categories: Search; Marketplace; Information and Entertainment; and Communications and Connected Life.

Search

Our Search offerings are often the starting point for users navigating the Internet and searching for information, whether from their computer or mobile device. Our vision is to enable users to find, use, share and expand all human knowledge, and we have made it our mission to provide the world's most valued and trusted search experience for users, publishers, advertisers and developers. Our Search product offerings include the following:

- **Search** — Yahoo! Search; Yahoo! Desktop Search; Yahoo! Toolbar; and Yahoo! Search on Mobile
- **Local** — Yahoo! Local; Yahoo! Yellow Pages; and Yahoo! Maps

Search

Yahoo! Search, our proprietary algorithmic search technology, provides users with a free comprehensive and highly relevant online search experience and free Internet search results sorted based on relevance to the user's search query. Yahoo! Search discovers and processes billions of documents on the Internet to give users a comprehensive, up to date, and relevant search experience. Pages on the Internet are ranked according to their relevance to a particular query by analyzing document features, including text, title and description accuracy, source, associated links, and other unique document characteristics. For example, if the user enters the phrase "hybrid car" into the Yahoo! Search box, the Yahoo! search technology will search the Internet and return links to what it identifies as the most relevant websites regarding "hybrid car" on the Internet. A single search gives immediate results from a database that is updated frequently to capture newly created and changing pages, including late breaking news and timely events.

We continue to focus on creating innovative, useful technologies that enable people to find, use, share and expand all human knowledge. In 2005, we launched our enhanced vertical search services including a beta version of Audio search, Video search and Image search. To further develop the "hybrid car" search example above, a user may select a search view link to focus the web results on images, news, video or other options relevant to the search topic. For example, by selecting the "Images" link and entering the search term "hybrid car", pictures of hybrid cars on the Internet will be returned.

Our innovative social search platform, My Web was also introduced in 2005. My Web is a "personal search engine" that extends users' existing Yahoo! Search experience by providing a simple way to save, recall and share online information with friends and colleagues. Our social search assets were further enhanced in 2005 by the acquisitions of Flickr and del.icio.us, Inc. Flickr is one of the Internet's most popular photo-sharing websites. Del.icio.us brought to Yahoo! social bookmarking technology, a well known technology brand, and a rapidly growing user base. Finally, in late 2005, we launched Yahoo! Answers, a platform that enables our users to post and answer questions in hundreds of categories ranging from Arts to News to Health.

Yahoo! Desktop Search is a free desktop application that indexes the information and content users have on their computer — e-mails, attachments, documents, music, images, videos, and more — making it easy to search for almost anything on their hard drive.

Yahoo! Toolbar is a free browser add-on that enables users to conveniently access our properties and services from anywhere on the Internet and provides free security services to enhance the user experience. In 2005, we created and launched a Toolbar for the increasingly popular Mozilla Firefox browser.

Yahoo! Search on Mobile provides users two ways to complete searches on their mobile devices — using a web browser or text messaging. In 2005, we launched text messaging search, which enables users to use text messaging to retrieve data from the Internet using any mobile phone that supports text messaging, while the enhanced web browser search functionality allows users to access Yahoo! Search on a wider variety of devices in addition to mobile phones.

Local

Our Local offerings include three individual properties whose primary services are available free to users: Yahoo! Local, Yahoo! Yellow Pages, and Yahoo! Maps.

Yahoo! Local is a stand-alone offering, using content and technology from other properties such as Yahoo! Yellow Pages and Yahoo! Maps to help users find information on a local level. In 2005, we launched the next generation version of Yahoo! Local including new features such as interactive maps, user reviews and ratings and local event listings to enhance the local search experience through rich community generated content. Yahoo! Local offers businesses a free service called Yahoo! Local Basic Listing allowing them to post detailed company information, such as their business hours, contact information, product/services

offered and website address for Yahoo! Local users to see. Businesses can submit additional content such as photos, logo and/or marketing information for a monthly fee through the Yahoo! Local Enhanced Listing service. We also offer Featured Listings, which enable businesses to buy listing advertisements in the Sponsor Results sections of Yahoo! Local. These Featured Listings meet the local advertiser demands for high visibility.

Yahoo! Yellow Pages enables users to quickly connect to local and national merchants in the United States. Businesses can also choose to pay to have their listings placed in the Sponsored Business section, which appears above the regular non-paid yellow page listings.

Yahoo! Maps provides interactive maps with zooming, real time traffic conditions and incident reports, together with integrated driving directions. In 2005, we launched an enhanced version of Yahoo! Maps with an improved user interface, which provides users an interactive look and feel with new features such as multi-point driving directions, local content integration, larger main map and dynamic pan, zoom and re-center technology.

Marketplace

Marketplace offerings are often the starting point for users seeking to purchase products and services on the Internet and seeking to access free services on the Internet. Our specific Marketplace product offerings include the following:

- **Shopping** — Yahoo! Shopping; Kelkoo; Yahoo! Auctions; and Yahoo! Real Estate
- **Travel** — Yahoo! Travel
- **Autos** — Yahoo! Autos
- **Personals** — Yahoo! Personals; and Yahoo! Personals Premier
- **Jobs** — Yahoo! HotJobs
- **Small Business** — Yahoo! Small Business

Shopping

Yahoo! Shopping provides comprehensive search functionality and comparison-shopping tools for users to find, research, compare and buy products online. This property also provides a full suite of merchant ratings and product review tools and in many countries includes the services of Kelkoo, S.A. ("Kelkoo"). We generate revenue from merchants when users click-through to their websites or through a revenue share of the final selling value when users purchase products. In late 2005, we launched a series of new features and functionality as part of our commitment to enhance community features. Two of the new features include Pick Lists which allow users to pick and share the most interesting products organized by topic and My Lists which allow each user to save products into lists that can be private or shared. In addition, we launched a beta version of Yahoo! Shopping Search on Mobile to enable users to compare product prices on their mobile devices.

Kelkoo is our European shopping platform, which became part of Yahoo! through an acquisition in 2004. It provides product search functionality and an online comparison shopping service with operations in 10 European countries and now also powers the Yahoo! Shopping services in Australia and Taiwan.

Yahoo! Auctions is incorporated into the Yahoo! Shopping platform and is a marketplace for buyers and sellers to trade goods in an auction-style setting. Yahoo! Auctions connects buyers and sellers and is available free of charge to buyers and sellers.

Yahoo! Real Estate provides information for home buyers and sellers. Yahoo! Real Estate enables users to search for listed properties based on geography, price and features. In addition, information regarding

moving-related content and services, advice about finding a real estate agent, neighborhoods, financing and insurance, home improvement ideas, and assistance in locating rentals and roommates, is available. Users can also pay to list a property in certain markets.

Travel

Yahoo! Travel is a comprehensive online travel guide that provides research and booking functionality for users to find, compare and conveniently purchase travel products such as airline tickets, hotel rooms, car rentals, vacation packages and cruises. We generate revenue from our travel partners through a revenue share of the booking value when users make travel arrangements on Yahoo! Travel. Separately, Yahoo! offers a travel search engine called Yahoo! FareChase. Yahoo! FareChase is an extension of our search offerings that allows users to search for travel information from multiple travel service providers' websites simultaneously and obtain results from all providers on one page for purposes of comparison shopping. This service is available free of charge to users and suppliers of travel products and online travel agents.

Autos

Yahoo! Autos enables users to research, price and compare cars online. Information and services available free of charge to our users include vehicle pricing, specification and option information, used car listings, expert reviews, user reviews and ratings, car comparisons, financing calculators, and new car quotes from dealers. We generate revenue from users who pay to list used cars for sale or for premium research content. In addition, we earn fees on a per lead basis for transactions completed between our users and automotive manufacturers and dealers. In 2005, Yahoo! Autos launched Custom, a community site for automotive enthusiasts that allows them to find, use, share and expand auto-related knowledge. Custom enables users to create profiles for their cars, share photos, communicate on message boards and search for local mechanics and relevant automotive information.

Personals

Yahoo! Personals is a leading online dating service. It allows users, free of charge, to post a profile and search for others with whom to communicate within the Yahoo! Personals community. Users can also send short one-time messages to others to communicate their interest without charge. With a paid subscription, Yahoo! Personals' users can e-mail and use Yahoo! Messenger to communicate with others in the Yahoo! Personals community. The standard Yahoo! Personals subscription service serves a large population of daters with a newly optimized user experience that is tailored to meet the needs of today's online daters. Yahoo! Personals Premier offers deeper profiling and advanced searching tools.

Jobs

Yahoo! HotJobs is a leader in the online recruiting industry, providing comprehensive solutions for employers, staffing firms and job seekers. Yahoo! HotJobs' tools and advice put job seekers in control of their career search and we believe make it easier and more cost-effective for recruiters and employers to find qualified candidates compared to traditional methods. Yahoo! HotJobs enables job seekers to create an online resume and to search and apply for jobs, and provides access to newsletters, online forums and salary research, free of charge. In 2005, we launched a new job search engine that enables job seekers to find jobs from across the Internet at Yahoo! HotJobs including listings from other employer and job-related websites in addition to job listings on our website. We generate revenue from employers and staffing firms that pay to access our database of job seekers and use our tools to post, track and manage job openings.

Small Business

Yahoo! Small Business provides a comprehensive and integrated suite of fee-based online services including Yahoo! Domains, Yahoo! Web Hosting, Yahoo! Business Mail and our e-commerce platform called Yahoo! Merchant Solutions. By integrating one of the leading hosting solutions with business critical services and information, Yahoo! enables customers to easily get online, sell online, and market and promote online.

Information and Entertainment

Our Information and Entertainment offerings deliver content that is available without charge to our users, and also provide some of our content on a fee or subscription basis. Our Information and Entertainment offerings include the following:

- **Information** — Yahoo! Front Page (www.yahoo.com); My Yahoo!; Yahoo! News; Yahoo! Finance; Yahoo! Health; and Yahoo! Education
- **Entertainment** — Yahoo! Sports; Yahoo! Music; Yahoo! Movies; Yahoo! TV; Yahoo! Games; and Yahooligans!

Information

Yahoo! Front Page (www.yahoo.com) serves as a free navigation hub and entry point into the Yahoo! Properties. Among many available features on the page are the ability to perform a Internet search, read the latest news, link to Yahoo! websites in the Yahoo! Properties, and view promotions from Yahoo!'s advertisers.

My Yahoo! is our free, personalized Web information service that allows registered members to create a personal profile, which organizes and delivers information of personal interest to the user via a user-customized interface. The My Yahoo! platform allows us to deliver targeted advertising and transaction-based services on behalf of our advertisers and partners.

Yahoo! News aggregates news stories from news providers such as the Associated Press, Reuters, AFP, The Washington Post, USA TODAY, Chicago Tribune, National Public Radio, and U.S. News and World Report. Through Yahoo! News, users receive free up-to-the-minute news coverage with text, photos, audio and video, from multiple sources and points of view. In 2005, we launched two additional exclusive features: *Kevin Sites in the Hot Zone* and *Richard Bangs Adventures*. Kevin Sites in the Hot Zone features news reporting on armed conflict in the world. Richard Bangs Adventures captures untold stories about adventurers and explorers around the world.

Yahoo! Finance provides a comprehensive set of financial resources that range from investment and company information to personal finance management tools. Yahoo! Finance offers free financial tools to help users manage their personal finances as well as data, news and information for making informed investment decisions. In 2005, we added additional exclusive content from financial experts focusing on a variety of personal finance and investing topics. We also launched our direct-to-exchange product, which allows Yahoo! Finance to receive, and make available to users, stock quotes directly from exchanges around the world. In addition, Yahoo! Finance offers fee-based services, including a real-time stock quotes package, company conference call transcripts, and analyst research reports.

Yahoo! Health is a comprehensive starting point for users to find healthcare information. Yahoo! Health provides free information on healthy living, medical conditions and medications, as well as listings for various health information centers, clinical trial information and online community tools. In 2005, we introduced blogs provided by leading experts that share advice, tips, and personal experiences on topics from allergies to yoga.

Entertainment

Yahoo! Sports provides a fast, live and interactive online experience for sports fans including original fantasy games, up-to-the-minute news, real-time statistics and scoring, broadcast programming, integrated shopping, and an online sports community. Yahoo! Sports has content and marketing relationships with professional sports organizations and media outlets including the National Basketball Association, Player's Inc., Sports Illustrated Interactive, USA Today and the Associated Press. Yahoo! Sports also offers fee-based fantasy games, real-time statistical trackers and live sports audio broadcasts.

Yahoo! Music offers users access to a wide selection of streaming audio, the Internet's largest collection of music videos, Internet radio, exclusive artist features and music news and related content covering all genres of music. Yahoo! Music also offers fee-based music services including premium radio and Musicmatch's subscription and download offerings. In 2005, we extended our premium music services with the introduction of Yahoo! Music Unlimited. With a library of more than one and a half million songs, the Yahoo! Music Unlimited subscription service is available to users for a low monthly or annual subscription fee. With Yahoo! Music Unlimited users can build personalized music libraries, transfer tracks to portable devices, purchase permanent downloads, access commercial-free Internet radio stations, and uniquely share and discover music with friends through Yahoo! Messenger. Subscribers benefit from personalized music recommendations based on their ratings and music taste, discounted permanent downloads, and the ability to create playlists from the song library.

Yahoo! Movies and *Yahoo! TV* offer entertainment services which include entertainment news, photo galleries, exclusive content such as trailers and extra or never-before-seen footage, and links to entertainment-related content across the Yahoo! Properties. Yahoo! Movies features paid-for film promotions for major movie studios, including Disney, Sony, Warner Bros., Universal and Fox. Yahoo! TV partners with key television networks, producers and content creators to give users a deeper, more engaging experience with their favorite programs. Additionally Yahoo! TV partners with Mark Burnett Productions to produce and host "The Apprentice" website on Yahoo! TV.

Yahoo! Games offers free classic board, card, arcade and word games along with downloadable games, game strategy guides, shopping guides, gaming news, tournaments, leagues and reviews on computer and console videogames. Our integration of games with Yahoo! Messenger allows users to see what games their friends are playing and join in the game through Yahoo! Messenger. Yahoo! Games also offers a variety of fee-based premium game downloads and subscriptions.

Yahooligans! is a free entertainment and educational Internet guide designed for children ages seven to twelve. Yahooligans! offerings include games, reference materials and movie information.

Communications and Connected Life

Our Communications and Connected Life offerings provide a wide range of communication and content services to users and small businesses including those that extend a wide range of Yahoo! services beyond the browser and across a variety of devices and through our access alliances. We offer some services free of charge to our users and also provide some of our services on a fee or subscription basis. Our offerings include the following:

- **Communications** — Yahoo! Mail; Yahoo! Messenger with Voice; Yahoo! Photos; and Yahoo! Communities
- **Connected Life** — Broadband; Yahoo! Mobile; and Yahoo! Go

Communications

Yahoo! Mail is a free global service available in over 20 languages that provides users with a full-featured e-mail experience including industry-leading spam and virus protection, significant free storage and attachment size capacity, advanced search capabilities, and robust address book functionality. In addition to our basic e-mail service, for a subscription fee we offer Yahoo! Mail Plus, a premium mail service providing a combination of these features plus a number of other premium features, including personalized spam filter, additional storage capacity, graphical ad blocker, and personalized stationery. In 2005, we launched a beta version of Yahoo! Mail, which provides a faster experience with enhanced functionality, such as drag and drop e-mail organization and message previews in addition to other enhanced features.

The *Yahoo! Messenger with Voice* instant messaging ("IM") service provides a free, interactive and personalized way for people to connect and share experiences with their friends, family and colleagues in real time. Yahoo! Messenger's communications suite integrates leading Yahoo! services including Games, Music, Photos, and Search. Yahoo! Messenger allows users to stay connected to one another through text IM, e-mail, video or mobile messaging. In 2005, we launched the next generation version of IM, which provides free PC-to-PC calling, photo sharing and enhanced tools to expand online communities. In addition, in 2005 we signed an agreement with Microsoft Corporation ("Microsoft") to globally connect users of Yahoo! Messenger and MSN Messenger to create what we expect to be among the largest IM communities in the world when released in 2006.

Yahoo! Photos makes it easy for people to upload, store and share their photos for free. For example, Yahoo! users can now share their pictures with a friend instantly using e-mail or Yahoo! Messenger. Users can also order high-quality prints and photo gifts as a premium service and pick-up their prints in one hour from their local Target store.

Yahoo! Communities help users build and manage identity and relationships and include properties such as Groups, Avatars, Chat, and Message Boards. In 2005, we launched a beta version of Yahoo! 360°, an innovative new service providing users with an integrated experience, seamlessly bringing together popular communications, content and community services such as Yahoo! Messenger, Yahoo! Photos, Yahoo! Music and Yahoo! Groups with sharing tools for recommending favorite movies, restaurants, music and more. Yahoo! Communities provide users with the opportunity to discover, connect and interact with other users who share similar interests and ideas.

Connected Life

Broadband — Yahoo! has several strategic alliances with various providers of broadband Internet service in the United States and internationally. The services we offer with our broadband partners include integrated Internet access and premium services on a subscription basis, customized and co-branded with each partner. We have a strategic alliance with the new AT&T Corp. ("AT&T", formerly SBC Communications Inc.) to offer a co-branded high-speed Internet service to DSL (broadband) customers in AT&T's 13-state local service footprint and to dial-up subscribers nationwide. In 2005, we launched a new service with Verizon Communications Inc. ("Verizon"), comprising a fully integrated co-branded broadband offering to subscribers of Verizon Online's DSL Internet access services. In the United Kingdom, we have a similar alliance with BT Group plc ("BT") offering co-branded DSL and dial-up services. In 2005, we announced a long-term extension of our alliance with BT to offer Yahoo! services to all new and existing BT Broadband customers. In Canada, we have an alliance with Rogers Cable Inc. ("Rogers") to offer Rogers Yahoo! Hi-Speed Internet. In October 2005, we announced a strategic alliance to deliver co-branded broadband service to BellSouth Corporation's ("BellSouth") Internet subscribers throughout BellSouth's region in the United States.

Yahoo! Mobile focuses on expanding the reach of Yahoo!'s leading services and content beyond the desktop to give users an integrated Internet experience from their personal computer ("PC") to their mobile device. Through relationships with leading mobile operators and device manufacturers around the world, including Nokia Corporation and Motorola, Inc., we offer a number of ways for users to connect their mobile devices to their Yahoo! content and community. Users can access Yahoo!'s Mobile Internet portal from their data-enabled phone to use a range of their Yahoo! services including Yahoo! Messenger, Yahoo! Mail and Yahoo! Finance. In addition, users can choose to buy a range of mobile services from Yahoo! including premium Yahoo! services and other mobile content such as downloadable Yahoo! Photos for Mobile applications, ringtones and mobile games. In 2005, we launched a number of new services including a downloadable Yahoo! Mail for Mobile application, enhancements to Yahoo! Search on Mobile and text messaging search. We generate revenue through a combination of premium subscriptions for Yahoo! services, fees from carriers for services that drive data usage and revenue share arrangements on distribution of premium mobile content.

Yahoo! Go is a new suite of existing and planned innovative applications designed to let users access the information and content they want across various devices including their PC, mobile device and PC-connected television. Yahoo! Go will integrate Yahoo!'s products and services, including community, information and content services from across the Internet, onto the user's PC, mobile device and PC-connected television. Yahoo! Go Desktop services will make it easy for users to keep up-to-date on and interact with their information without having to open a browser window on their PC. The initial Yahoo! Go Desktop service is Yahoo! Widgets, a collection of mini-applications that can perform a wide range of functions from displaying a weather forecast to playing a game. Yahoo! Go TV will bring the Internet to the PC-connected television screen. Yahoo! Go Mobile allows consumers to take the Internet services they use on their PC onto their mobile device in one simple, fully synchronized application. Yahoo! is working with companies including AT&T, Microsoft, Intel Corporation, Nokia and TiVo to bring these services to market. Yahoo! Go services are expected to be launched and accessible to our users in 2006 and are intended to provide a seamless connected experience for our users.

GEOGRAPHIC AREAS

We manage and measure our business geographically. Our principal geographies are the United States and International. We seek to build upon our global user base by developing Internet offerings focused on specific geographic regions both domestically and internationally. Additional information required by this item is incorporated herein by reference to Note 15 — "Segments" of the Notes to the Consolidated Financial Statements, which appears in Item 8 of this Annual Report on Form 10-K.

We provide services in more than 15 languages in over 20 countries, regions and territories, including localized versions of Yahoo! in Argentina, Australia, Brazil, Canada, China, France, Germany, Greece, Hong Kong, India, Italy, Japan, Korea, Malaysia, Mexico, Northern Europe and Scandinavia (Denmark, Sweden, Norway), Russia, Singapore, Spain, Taiwan, the United Kingdom and Ireland, and the United States. We also provide some of our most popular and point-of-entry services through Yahoo! Asia (our portal to Southeast Asia including Indonesia, Philippines, and Thailand), Yahoo! Chinese (United States Chinese language site), Yahoo! en Español (United States Hispanic site), Yahoo! Canada en français (French Canadian site) and Yahoo! en Català (part of Yahoo! Spain's Catalan language offerings). Outside of Yahoo's English-speaking markets, we have built independent, localized-language directories, websites and other content, developed by native speakers of each language. We own a majority or 100 percent of these international operations (except in Australia, China and Japan), and have established offices worldwide to facilitate the local development of these businesses. We have pursued a consistent strategy of content aggregation with leading third parties and currently plan to continue to introduce certain selected services for our international markets.

Our local version of Yahoo! in Japan is operated by Yahoo! Japan Corporation ("Yahoo! Japan"), a publicly traded company in Japan that is majority owned by SOFTBANK Corp. and its consolidated affiliates (collectively "SOFTBANK"). We have a joint venture in Japan with SOFTBANK, which was formed to establish and manage a local version of our properties. As of December 31, 2005, we owned approximately 34 percent of Yahoo! Japan.

During the year, we acquired full ownership of our joint ventures in the United Kingdom, France, Germany and Korea from SOFTBANK. Our local version of Yahoo! in each of these countries had previously been operated and managed by these joint ventures.

Additionally during the year, we purchased approximately 46 percent of the outstanding common stock of Alibaba, which represents approximately 40 percent on a fully diluted basis, in exchange for $1.0 billion in cash and the contribution of our China based businesses ("Yahoo! China").

SALES

We maintain three primary channels for selling our marketing services: telemarketing, online, and direct. Our telemarketing channel focuses on sales of marketing services to small and medium-size businesses. Our online channel is fulfilled by a self-service program that enables advertisers to place targeted text based links to their websites on the Yahoo! Properties as well as on our affiliates' websites. Our direct advertising sales team focuses on selling our marketing services and solutions to leading advertising agencies and marketers in the United States. During 2005, we aligned our graphical advertising sales team under the common leadership of our search sales team to better respond to our most important advertisers who are increasingly using both forms of advertising on Yahoo! Properties to achieve their desired marketing goals. No individual customer represented more than 10 percent of our revenues in 2003, 2004 or 2005.

We employ sales professionals in locations across the United States, including Atlanta, Boston, Chicago, Dallas, Detroit, the Los Angeles area, Miami, New York, San Francisco, and Sunnyvale. Our sales organization consults regularly with agencies and advertisers on design and placement of online advertising, and provides customers with measurements and analyses of advertising effectiveness as well as effective consumer insights that can be turned into marketing campaigns. In addition to our geographic sales structure, we have sales teams for automotive, consumer packaged goods, entertainment, finance, retail, pharmaceuticals, sports, technology, telecommunications and travel. In international markets, we have either our own internal sales professionals or we have established sales agency relationships in more than 20 countries.

MARKETING

We believe that world-class marketing can be a competitive advantage. The Yahoo! brand is one of the most widely recognized in the world. Maintaining and growing that brand enables us to attract, retain, and more deeply engage users and advertisers. We believe a great brand begins with a great product. Yahoo! marketing engages in each step of product development, deployment and management to understand our offerings and how best to market them to our audience of potential and existing users. Our marketing communications efforts help accelerate product momentum, awareness, adoption, and engagement. We use online, television, print, radio and outdoor advertising, and we leverage our global online network and our distribution partnerships to market our products and services to the right people at the right time. With continued investment in global brand and product marketing, we believe we can continue to attract and engage users and advertisers.

COMPETITION

We operate in the market for Internet products, services and content, which is a highly competitive market characterized by rapid change, converging technologies, and increasing competition from companies offering communication, information and entertainment services integrated into other products and media properties. We primarily compete with companies to attract users to our website and advertisers to our marketing services. We expect the market to become increasingly competitive if online marketing continues to grow and gain acceptance on a global basis.

Globally, our most significant competition is from Time Warner's America Online business ("AOL" or "America Online"), Google Inc. ("Google") and Microsoft.

The principal competitive factors relating to attracting and retaining users include the quality and relevance of our search results, and the usefulness, accessibility, integration and personalization of the online services that we offer as well as the overall user experience on our website. In the case of attracting advertisers, the principal competitive factors are the reach, effectiveness and efficiency of our marketing services as well as the creativity of the marketing solutions that we offer.

We also face competition from companies focused on markets where expertise in a particular segment of the market may provide them a competitive advantage. Two of these competitors, Amazon.com, Inc., and eBay Inc., are expanding their positions as e-commerce merchants to leverage advantages from the scale of their commerce platforms to offer informational, community, and communication features that are competitive with the some of the services we provide.

Internationally, we compete with local portals that are predominantly supported by the local telecommunication providers, or local providers of specific Internet services locally designed and marketed, which give them a potential competitive advantage because they typically already have a direct billing relationship with their users.

We believe that we are effectively competing in the market for Internet services as we continue to refine our search technology and build onto our existing online properties and services and further improve the experience of our users.

Additional information regarding competition is included in Part I, Item 1A "Risk Factors" of this Annual Report on Form 10-K.

PRODUCT DEVELOPMENT

We continually enhance and expand our existing offerings and develop new offerings to meet evolving user needs for technological innovation and a deeper more integrated user experience.

As a complement to our core engineering and production teams, we also have scientists working in our Yahoo! Research Labs dedicated to developing novel algorithms and technology that empower users, businesses, advertisers, and publishers worldwide to maximize the social and economic potential of the Internet. Yahoo! performs research to address fundamental problems facing users, such as: making their search for information on the Internet easier and more efficient; bringing them tools to help solve their problems; finding new and better ways for them to connect and communicate with family and friends; and guiding family and friends towards high-quality products, songs, movies, and other resources. We also help advertisers connect with customers most likely to be interested in their products, maximizing the advertisers' marketing investments and providing a better overall user experience.

Our engineering and production teams are primarily located in our Sunnyvale, California headquarters and in Burbank, California; Dallas, Texas; and Bangalore, India. Our research teams are located in our Sunnyvale, California headquarters and in Berkeley, California; Burbank, California; New York, New York; Barcelona, Spain; and Santiago, Chile. Domestic teams handle most international product

development and engineering. We have developed internally, acquired or licensed the products and services we offer. Product development expenses totaled approximately $207 million, $369 million, and $547 million for 2003, 2004, and 2005, respectively.

INTELLECTUAL PROPERTY

We create, own and maintain a wide array of intellectual property assets that we believe are among our most valuable assets. Our intellectual property assets include patents and patent applications related to our innovations, products and services; trademarks related to our brands, products and services; copyrights in software and creative content; trade secrets; and other intellectual property rights and licenses of various kinds. We seek to protect our intellectual property assets through patent, copyright, trade secret, trademark and other laws of the United States and other countries of the world, and through contractual provisions. We enter into confidentiality and invention assignment agreements with our employees and contractors, and non-disclosure agreements with third parties with whom we conduct business in order to limit access to, and disclosure of, our proprietary information. We consider the Yahoo! trademark and our many related trademarks to be among our most valuable assets and we have registered these trademarks in the United States and other countries throughout the world and aggressively seek to protect them. We have licensed in the past, and expect that we may license in the future, certain of our proprietary rights, such as trademark, patent, copyright and trade secret rights to third parties. Additional information regarding certain risks related to our intellectual property is included in Part I, Item 1A "Risk Factors" of this Annual Report on Form 10-K.

EMPLOYEES

As of December 31, 2005, we had approximately 9,800 full-time employees. Our future success is substantially dependent on the performance of our senior management and key technical personnel, and our continuing ability to attract and retain highly qualified technical and managerial personnel. Additional information regarding certain risks related to our employees is included in Part I, Item 1A "Risk Factors" of this Annual Report on Form 10-K.

AVAILABLE INFORMATION

Our website is located at http://www.yahoo.com. Our investor relations website is located at http://yhoo.client.shareholder.com/. We make available free of charge on our investor relations website under "SEC Filings" our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and any amendments to those reports as soon as reasonably practicable after we electronically file or furnish such materials to the U.S. Securities and Exchange Commission ("SEC"). Further, a copy of this annual report on Form 10-K is located at the SEC's Public Reference Room at 450 Fifth Street, NW, Washington, D.C. 20549. Information on the operation of the Public Reference Room can be obtained by calling the SEC at 1-800-SEC-0330. The SEC maintains an Internet site that contains reports, proxy and information statements and other information regarding our filings at http://www.sec.gov.

Item 1A. Risk Factors

We face significant competition from large-scale Internet content, product and service aggregators, principally Time Warner's AOL, Google and Microsoft.

We face significant competition from companies, principally AOL, Google, and Microsoft, that have aggregated a variety of Internet products, services and content in a manner similar to Yahoo!. AOL has access to content from Time Warner's movie, television, music, book, periodical, news, sports and other media holdings; access to a network of cable and other broadband users and delivery technologies; and considerable resources for future growth and expansion. Google, in addition to an Internet search service, offers many other serviees that directly compete with our services, including a consumer e-mail service, desktop search, local search, instant messaging, photos, maps, shopping services and advertising solutions. Microsoft has introduced its own Internet search service and has announced plans to develop both paid search and features that may make Internet searching capabilities a more integrated part of its Windows operating system. We expect these competitors increasingly to use their financial and engineering resources to compete with us, individually, and potentially in combination with each other. In certain of these cases, most notably AOL, our competition has a direct billing relationship with a greater number of their users through Internet access and other services than we have with our users through our premium services. This relationship may permit these competitors to be more effective than us in targeting services and advertisements to the specific preferences of their users thereby giving them a competitive advantage. If our competitors are more successful than we are in developing compelling products or attracting and retaining users or advertisers, then our revenues and growth rates could decline.

We also face competition from other Internet service companies, including Internet access providers, device manufacturers offering online services and destination websites.

Our users must access our services through Internet access providers, including wireless providers and providers of cable and broadband Internet access. To the extent that an access provider or device manufacturer offers online services competitive with those of Yahoo!, the user may elect to use the services or properties of that access provider or manufacturer. In addition, the access provider or manufacturer may make it difficult to access our services by not listing them in the access provider's or manufacturer's own directory or by providing Yahoo! with less prominent listings than the access provider, manufacturer, or a competitor's offerings. Such access providers and manufacturers may prove better able to target services and advertisements to the preferences of their users. If such access providers and device manufacturers are more successful than we are in developing compelling products or attracting and retaining customers, users or advertisers, then our revenues could decline. Further, to the extent that Internet access providers, mobile service providers or network providers increase the costs of service to users or restrict Yahoo!'s ability to deliver products, services and content to end users or increase our costs of doing so, our revenues could decline.

We also compete for customers, users and advertisers with many other providers of online services, including destination websites. Some of these competitors may have more expertise in a particular segment of the market, and within such segment, have longer operating histories, larger advertiser or user bases, and more brand recognition or technological features than we offer.

In the future, competitors may acquire additional competitive offerings or consolidate with each other to become more competitive, and new competitors may enter the market. If our competitors are more successful than we are in developing compelling products or attracting and retaining users, advertisers or customers, then our revenues and growth rates could decline.

We face competition from other providers of search marketing that could affect our operating results.

We compete directly with other providers of search marketing, including Google, LookSmart, Ltd., Lycos Inc., Microsoft, and MIVA (formerly FindWhat.com). In addition, we believe it is likely that there will be additional entrants to this advertising market. Some of the existing competitors and possible additional entrants may have greater operational, strategic, financial, personnel or other resources than we do, as well as greater brand recognition. These competitors compete against us for affiliate and advertiser arrangements and could cause us to have to enter into such arrangements with less favorable terms, to lose current affiliates or advertisers or to fail to acquire new affiliates or advertisers. The loss of affiliates or advertisers or a reduction in the revenue from such arrangements could harm our business and operating results.

We face significant competition from traditional media companies which could adversely affect our future operating results.

We also compete with traditional media companies for advertising. Most advertisers currently spend only a small portion of their advertising budgets on Internet advertising. If we fail to persuade existing advertisers to retain and increase their spending with us and if we fail to persuade new advertisers to spend a portion of their budget on advertising with us, our revenues could decline and our future operating results could be adversely affected.

If we are unable to provide search technologies and other services which generate significant traffic to our websites, or we are unable to enter into distribution relationships which drive significant traffic to our websites, our business could be harmed, causing our revenues to decline.

We have deployed our own Internet search technology to provide search results on our network. We have more limited experience in operating our own search service than do some of our competitors. Internet search is characterized by rapidly changing technology, significant competition, evolving industry standards and frequent product and service enhancements. We must continually invest in improving our users' experience, including search relevance, speed and services responsive to their needs and preferences, to continue to attract, retain and expand our user base. If we are unable to provide search technologies and other services which generate significant traffic to our websites, or if we are unable to enter into distribution relationships that continue to drive significant traffic to our websites, our business could be harmed, causing our revenues to decline.

The majority of our revenues are derived from marketing services, and the reduction in spending by or loss of current or potential advertisers would cause our revenues and operating results to decline.

For the year ended December 31, 2005, 87 percent of our total revenues came from marketing services. Our ability to continue to retain and grow marketing services revenue depends upon:

- maintaining our user base;
- broadening our relationships with advertisers to small and medium size businesses;
- attracting advertisers to our user base;
- increasing demand for our marketing services by advertisers, users and businesses, including prices paid by advertisers, the number of searches performed by users and the rate at which users click-through to commercial search results;
- the effectiveness, and acceptance by advertisers, of our systems improvements to increase monetization of our search marketing;
- maintaining our affiliate program for our search marketing;

- deriving better demographic and other information from our users; and
- driving continued acceptance of the web by advertisers as an advertising medium.

In many cases, our agreements with advertisers have terms of one year or less, or, in the case of search marketing, may be terminated at any time by the advertiser. Search marketing agreements often have payments contingent upon usage or click-through levels. Accordingly, it is difficult to forecast marketing services revenues accurately. However, our expense levels are based in part on expectations of future revenues, including occasional guaranteed minimum payments to our affiliates in connection with search marketing, and are fixed over the short-term with respect to certain categories. Any reduction in spending by or loss of existing or potential future advertisers would cause our revenues to decline. Further, we may be unable to adjust spending quickly enough to compensate for any unexpected revenue shortfall.

In certain markets, we depend on a limited number of sources to direct a significant percentage of users and businesses to our service to conduct searches and a loss of any of these sources could harm our operating results.

A significant percentage of users and businesses that conduct searches and access our search marketing listings comes from a limited number of sources in certain markets. In addition to the Yahoo! Properties, sources for users are members of our affiliate network, including portals, browsers and other affiliates. Our agreements with affiliates vary in duration, and depending on the agreement, provide varying levels of discretion to the affiliate in the implementation of search marketing, including the degree to which affiliates can modify the presentation of the search marketing listings on their websites or integrate search marketing with their own services. The agreements may be terminable upon the occurrence of certain events, including failure to meet certain service levels, material breaches of agreement terms, changes in control or in some instances, at will. We may not be successful in renewing our affiliate agreements on as favorable terms or at all. The loss of affiliates providing significant users or businesses or an adverse change in implementation of search marketing by any of these affiliates could harm our ability to generate revenue, our operating results and cash flows from operations.

We may not be able to generate substantial revenues from our alliances with Internet access providers.

Through alliances with Internet access providers, we offer access services that combine customized content and services from Yahoo! (including browser and other communications services) and Internet access from the third party access providers. We may not be able to retain the alliances with our existing Internet access providers or to obtain new alliances with Internet access providers on terms that are reasonable. In addition, these Internet access services compete with many large companies such as AOL, Microsoft, Comcast Corporation and other established Internet access providers. In certain of these cases, our competition has substantially greater market presence (including an existing user base) and greater financial, technical, marketing or other resources. As a result of these and other competitive factors, the Internet access providers with which we have formed alliances may not be able to attract, grow or retain their customer bases, which would negatively impact our ability to sell customized content and services through this channel and, in turn, reduce our anticipated revenues from our alliances.

Some of our shared revenue arrangements may not generate anticipated revenues.

We typically receive co-branded revenue through revenue sharing arrangements or a portion of transactions revenue. In some cases, our revenue arrangements require that minimum levels of user impressions be provided by us. These arrangements expose us to potentially significant financial risks in the event our usage levels decrease, including the following:

- the revenue we are entitled to receive may be adjusted downwards;

- we may be required to "make good" on our obligations by providing additional advertising or alternative services;
- the partners or co-brand services may not renew the arrangements or may renew at lower rates; and
- the arrangements may not generate anticipated levels of shared transactions revenue, or partners may default on the payment commitments in such agreements as has occurred in the past.

Accordingly, any leveling off or decrease of our user base (or usage by our existing base) or the failure to generate anticipated levels of shared transactions revenue could result in a significant decrease in our revenues.

Decreases or delays in advertising spending by our advertisers due to general economic conditions could harm our ability to generate advertising revenue.

Expenditures by advertisers tend to be cyclical, reflecting overall economic conditions and budgeting and buying patterns. Since we derive the majority of our revenues from advertising, any decreases in or delays in advertising spending due to general economic conditions could reduce our revenues or negatively impact our ability to grow our revenues.

Financial results for any particular period do not predict results for future periods.

There can be no assurance that the purchasing pattern of advertisers on the Yahoo! Properties will not fluctuate, that advertisers will not make smaller and shorter-term purchases, or that market prices for online advertising will not decrease due to competitive or other factors. In addition, there can be no assurance that the volume of searches conducted, the amounts bid by advertisers for search marketing listings or the number of advertisers that bid in our search marketing marketplace will not vary widely from period to period. As revenues from new sources increase, it may become more difficult to predict our financial results based on historical performance. You should not rely on the results for any period as an indication of future performance.

We rely on the value of the Yahoo! brands, and a failure to maintain or enhance the Yahoo! brands in a cost-effective manner could harm our operating results.

We believe that maintaining and enhancing the Yahoo! brands is an important aspect of our efforts to attract and expand our user and advertiser base. We also believe that the importance of brand recognition will increase due to the relatively low barriers to entry in the Internet market. We have spent considerable money and resources to date on the establishment and maintenance of the Yahoo! brands, and we anticipate spending increasing amounts of money on, and devoting greater resources to, advertising, marketing and other brand-building efforts to preserve and enhance consumer awareness of the Yahoo! brands. We may not be able to successfully maintain or enhance consumer awareness of the Yahoo! brands and, even if we are successful in our branding efforts, these efforts may not be cost-effective. If we are unable to maintain or enhance customer awareness of the Yahoo! brands in a cost-effective manner, our business, operating results and financial condition could be harmed.

If we are unable to license or acquire compelling content at reasonable costs or if we do not develop compelling content, the number of users of our services may not grow as anticipated, or may decline, which could harm our operating results.

Our future success depends in part upon our ability to aggregate compelling content and deliver that content through our online properties. We license much of the content on our online properties, such as news items, stock quotes, weather reports, maps and audio and video content from third parties. We have been providing increasing amounts of audio and video content to our users, and we believe that users will

increasingly demand high-quality audio and video content, such as music, film, speeches, news footage, concerts and other special events. Such content may require us to make substantial payments to third parties from whom we license or acquire such content. For example, our music and entertainment properties rely on major sports organizations, radio and television stations, record labels, music publishers, cable networks, businesses, colleges and universities, film producers and distributors, and other organizations for a large portion of the content available on our properties. Our ability to maintain and build relationships with third-party content providers will be critical to our success. In addition, as new methods for accessing the Internet become available, including through alternative devices, we may need to enter into amended content agreements with existing third-party content providers to cover the new devices. Also, to the extent that Yahoo! develops content of its own, Yahoo!'s current and potential third-party content providers may view our services as competitive with their own, and this may adversely affect their willingness to contract with us. We may be unable to enter into new, or preserve existing, relationships with the third parties whose content we seek to obtain. In addition, as competition for compelling content increases both domestically and internationally, our content providers may increase the prices at which they offer their content to us, and potential content providers may not offer their content on terms agreeable to us. An increase in the prices charged to us by third-party content providers could harm our operating results and financial condition. Further, many of our content licenses with third parties are non-exclusive. Accordingly, other webcasters and other media such as radio or television may be able to offer similar or identical content. This increases the importance of our ability to deliver compelling editorial content and personalization of this content for users in order to differentiate Yahoo! from other businesses. If we are unable to license or acquire compelling content at reasonable prices, if other companies broadcast content that is similar to or the same as that provided by Yahoo!, or if we do not develop compelling editorial content or personalization services, the number of users of our services may not grow as anticipated, or may decline, which could harm our operating results.

Our intellectual property rights are valuable, and any inability to protect them could reduce the value of our brand image and harm our business and our operating results.

We create, own and maintain a wide array of intellectual property assets, including copyrights, patents, trademarks, trade dress, trade secrets and rights to certain domain names, which we believe are among our most valuable assets. We seek to protect our intellectual property assets through patent, copyright, trade secret, trademark and other laws of the United States and other countries of the world, and through contractual provisions. The efforts we have taken to protect our intellectual property and proprietary rights may not be sufficient or effective at stopping unauthorized use of those rights. In addition, effective trademark, patent, copyright and trade secret protection may not be available or cost-effective in every country in which our products and media properties are distributed or made available through the Internet. There may be instances where we are not able to fully protect or utilize our intellectual property assets in a manner to maximize competitive advantages. Further, while we attempt to ensure that the quality of our brand is maintained by our licensees, our licensees may take actions that could impair the value of our brand, our proprietary rights or the reputation of our products and media properties. We are aware that third parties have, from time to time, copied significant content available on Yahoo! for use in competitive Internet services. Protection of the distinctive elements of Yahoo! may not be available under copyright law. If we are unable to protect our proprietary rights from unauthorized use, the value of our brand image may be reduced. Any impairment of our brand could negatively impact our business. In addition, protecting our intellectual property and other proprietary rights is expensive and time consuming. Any increase in the unauthorized use of our intellectual property could make it more expensive to do business and consequently harm our operating results.

We are, and may in the future be, subject to intellectual property infringement claims, which are costly to defend, could result in significant damage awards, and could limit our ability to provide certain content or use certain technologies in the future.

Internet, technology, media companies and patent holding companies often possess a significant number of patents. Further, many of these companies and other parties are actively developing or purchasing search, indexing, electronic commerce and other Internet-related technologies, as well as a variety of online business models and methods. We believe that these parties will continue to take steps to protect these technologies, including, but not limited to, seeking patent protection. As a result, disputes regarding the ownership of technologies and rights associated with online business are likely to continue to arise in the future. From time to time, parties assert patent infringement claims against us. Currently, we are engaged in several lawsuits regarding patent issues and have been notified of a number of other potential disputes.

In addition to patent claims, third parties have asserted, and are likely in the future to assert, claims against us alleging infringement of copyrights, trademark rights, trade secret rights or other proprietary rights, or alleging unfair competition or violations of privacy rights or failure to maintain confidentiality of user data. Currently, our subsidiary LAUNCH Media, Inc. ("LAUNCH") is engaged in a lawsuit regarding copyright issues that commenced prior to our acquisition of LAUNCH. In addition, third parties have made, and may continue to make, trademark infringement and related claims against us over the display of search results triggered by search terms that include trademark terms. A court in France has held us liable for displaying search results triggered by certain trademarked terms, and we are appealing that decision.

As we expand our business and develop new technologies, products and services, we may become increasingly subject to intellectual property infringement claims. In the event that there is a determination that we have infringed third-party proprietary rights such as patents, copyrights, trademark rights, trade secret rights or other third party rights such as publicity and privacy rights, we could incur substantial monetary liability, be required to enter into costly royalty or licensing agreements or be prevented from using the rights, which could require us to change our business practices in the future and limit our ability to compete effectively. We may also incur substantial expenses in defending against third-party infringement claims regardless of the merit of such claims. In addition, many of our agreements with our customers or affiliates require us to indemnify them for certain third-party intellectual property infringement claims, which could increase our costs in defending such claims and our damages. The occurrence of any of these results could harm our brand and negatively impact our operating results.

We are subject to United States and foreign government regulation of the Internet and Voice over Internet Protocol services which could subject us to claims and remedies including monetary liabilities and limitations on our business practices.

We are subject to regulations and laws directly applicable to providers of Internet and Voice over Internet Protocol services both domestically and internationally. The application of existing domestic and international laws and regulations to Yahoo! relating to issues such as user privacy and data protection, defamation, pricing, advertising, taxation, gambling, sweepstakes, promotions, financial market regulation, consumer protection, content regulation, quality of services, telecommunications and intellectual property ownership and infringement in many instances is unclear or unsettled. In addition, we will also be subject to any new laws and regulations directly applicable to our domestic and international activities. Further, the application of existing laws to Yahoo! or our subsidiaries regulating or requiring licenses for certain businesses of our advertisers including, for example, distribution of pharmaceuticals, alcohol, adult content, tobacco or firearms, as well as insurance and securities brokerage and legal services, can be unclear. Internationally, we may also be subject to domestic laws regulating our activities in foreign countries and to foreign laws and regulations that are inconsistent from country to country. We may incur substantial liabilities for expenses necessary to comply with these laws and regulations or penalties for any

failure to comply. Compliance with these laws and regulations may also cause us to change or limit our business practices in a manner adverse to our business.

A number of federal laws, including those referenced below, impact our business. The Digital Millennium Copyright Act ("DMCA") is intended, in part, to limit the liability of eligible online service providers for listing or linking to third-party websites that include materials that infringe copyrights or other rights of others. Portions of the Communications Decency Act ("CDA") are intended to provide statutory protections to online service providers who distribute third party content. Yahoo! relies on the protections provided by both the DMCA and CDA in conducting its business. Any changes in these laws or judicial interpretations narrowing their protections will subject us to greater risk of liability and may increase our costs of compliance with these regulations or limit our ability to operate certain lines of business. The Children's Online Protection Act and the Children's Online Privacy Protection Act are intended to restrict the distribution of certain materials deemed harmful to children and impose additional restrictions on the ability of online services to collect user information from minors. In addition, the Protection of Children From Sexual Predators Act of 1998 requires online service providers to report evidence of violations of federal child pornography laws under certain circumstances. The costs of compliance with these regulations may increase in the future as a result of changes in the regulations or the interpretation of them. Further, any failures on our part to comply with these regulations may subject us to significant liabilities.

Changes in regulations or user concerns regarding privacy and protection of user data could adversely affect our business.

Federal, state and international laws and regulations may govern the collection, use, sharing and security of data that we receive from our users and partners. In addition, we have and post on our website our own privacy policies and practices concerning the collection, use and disclosure of user data. Any failure, or perceived failure, by us to comply with our posted privacy policies or with any data-related consent orders, Federal Trade Commission requirements or other federal, state or international privacy-related laws and regulations could result in proceedings or actions against us by governmental entities or others, which could potentially have an adverse effect on our business.

Further, failure or perceived failure to comply with our policies or applicable requirements related to the collection, use, sharing or security of personal information or other privacy-related matters could result in a loss of user confidence in us and ultimately in a loss of users, partners or advertisers, which could adversely affect our business.

There are a large number of legislative proposals pending before the United States Congress, various state legislative bodies and foreign governments concerning privacy issues related to our business. It is not possible to predict whether or when such legislation may be adopted. Certain proposals, if adopted, could impose requirements that may result in a decrease in our user registrations and revenues. In addition, the interpretation and application of user data protection laws are in a state of flux. These laws may be interpreted and applied inconsistently from country to country and inconsistently with our current data protection policies and practices. Complying with these varying international requirements could cause us to incur substantial costs or require us to change our business practices in a manner adverse to our business.

Acquisitions and strategic investments could result in adverse impacts on our operations and in unanticipated liabilities.

We have acquired, and made strategic investments in, a number of companies (including through joint ventures) in the past and expect to make additional acquisitions and strategic investments in the future. Such transactions may result in dilutive issuances of equity securities, use of our cash resources, incurrence

of debt and amortization of expenses related to intangible assets. Our acquisitions and strategic investments to date were accompanied by a number of risks, including:

- the difficulty of assimilating the operations and personnel of our acquired companies into our operations;
- the potential disruption of our ongoing business and distraction of management;
- additional operating losses and expenses of the businesses we acquired or in which we invested;
- the difficulty of integrating acquired technology and rights into our services and unanticipated expenses related to such integration;
- the failure to successfully further develop acquired technology resulting in the impairment of amounts currently capitalized as intangible assets;
- the potential for patent and trademark infringement claims against the acquired company;
- the impairment of relationships with customers and partners of the companies we acquired or in which we invested or our customers and partners as a result of the integration of acquired operations;
- the impairment of relationships with employees of the acquired companies or our employees as a result of integration of new management personnel;
- the difficulty of integrating the acquired company's accounting, management information, human resources and other administrative systems;
- our lack of, or limitations on, our control over the operations of our joint venture companies;
- in the case of foreign acquisitions, uncertainty regarding foreign laws and regulations and difficulty integrating operations and systems as a result of cultural, systems and operational differences; and
- the impact of known potential liabilities or unknown liabilities associated with the companies we acquired or in which we invested.

We are likely to experience similar risks in connection with our future acquisitions and strategic investments. Our failure to be successful in addressing these risks or other problems encountered in connection with our past or future acquisitions and strategic investments could cause us to fail to realize the anticipated benefits of such acquisitions or investments, incur unanticipated liabilities and harm our business generally.

Our failure to manage growth and diversification of our business could harm us.

We are continuing to grow and diversify our business both in the United States and internationally. As a result, we must expand and adapt our operational infrastructure and increase the number of our personnel in certain areas. Our business relies on our data systems, billing systems for our fee based and other services, and other operational and financial reporting and control systems. All of these systems have become increasingly complex in the recent past due to the growing diversification and complexity of our business and to acquisitions of new businesses with different systems. To effectively manage this growth, we will need to continue to upgrade and improve our data systems, billing systems, and other operational and financial systems, procedures and controls. In particular, as our premium and other services for which we bill users grow, any failure of our billing systems to accommodate the increasing number of transactions and accurately bill users could adversely affect our business and ability to collect revenue. These upgrades and improvements will require a dedication of resources and in some cases are likely to be complex. If we

are unable to adapt our systems in a timely manner to accommodate our growth, our business may be adversely affected.

Additionally, we have experienced recent growth in personnel numbers and expect to continue to hire additional personnel in selected areas. This growth requires significant time and resource commitments from our senior management. Further, as a result of recent acquisitions and international expansion, more than one-half of our employees are based outside of our Sunnyvale, California headquarters. If we are unable to effectively manage a large and geographically dispersed group of employees or to anticipate our future growth and personnel needs, our business may be adversely affected.

We have dedicated considerable resources to provide a variety of premium services, which may not prove to be successful in generating significant revenue for us.

We offer fee-based enhancements to many of our free services, including e-mail, personals, finance, games, music and sports. The development cycles for these technologies are long and generally require significant investment by us. We have previously discontinued certain non-profitable premium services. We must however continue to provide new services that are compelling to our users while continuing to develop an effective method for generating revenues for such services. General economic conditions may affect users' willingness to pay for such services. If we cannot generate revenues from these services that are greater than the cost of providing such services, our operating results could be harmed.

We expect our operating expenses to continue to increase as we attempt to expand the Yahoo! brand, fund product development, develop media properties and acquire other businesses or technologies, which could harm our operating results.

We currently expect that our operating expenses will continue to increase as we expand our operations in areas of expected growth, continue to develop and extend the Yahoo! brand, fund greater levels of product development, develop and commercialize additional media properties and premium services, and acquire and integrate complementary businesses and technologies. If our expenses increase at a greater pace than our revenues, our operating results could be harmed.

If we are unable to retain our existing senior management and key personnel and hire new highly skilled personnel, we may not be able to execute our business plan.

We are substantially dependent on the continued services of our senior management, including our two founders, our chief executive officer, chief financial officer, chief operating officer, chief technical officer, and our executive and senior vice presidents. These individuals have acquired specialized knowledge and skills with respect to Yahoo! and its operations. The loss of any of these individuals could harm our business. Our business is also dependent on our ability to retain, hire and motivate talented, highly skilled personnel. The competition for such highly skilled personnel can be intense, particularly in the San Francisco Bay Area, where our corporate headquarters is located. Many of our management and key personnel have reached or will soon reach the four-year anniversary of their Yahoo! hiring date and, as a result, have become or will shortly become fully vested in their initial stock option grants. Although employees receive additional grants, an employee may be more likely to leave Yahoo! upon completion of the vesting period for the initial option grant, which is generally the largest option grant an employee receives. If we do not succeed in retaining and motivating our existing key employees and in attracting new key personnel, we may be unable to meet our business plan and as a result, our stock price may decline.

More individuals are utilizing non-PC devices to access the Internet, and versions of our service developed or optimized for these devices may not gain widespread adoption by users, manufacturers or distributors of such devices.

The number of individuals who access the Internet through devices other than a personal computer, such as personal digital assistants, mobile telephones and television set-top devices, has increased dramatically. Our services were originally designed for rich, graphical environments such as those available on desktop and laptop computers. The lower resolution, functionality and memory associated with alternative devices currently available may make the use of our services through such devices difficult, and the versions of our service developed for these devices may not be compelling to users, manufacturers or distributors of alternative devices. As we have limited experience to date in operating versions of our service developed or optimized for users of alternative devices, and as new devices and new platforms are continually being released, it is difficult to predict the problems we may encounter in doing so, and we may need to devote significant resources to the creation, support and maintenance of such versions. If we are unable to attract and retain a substantial number of alternative device users to our online services, we may fail to capture a sufficient share of an increasingly important portion of the market for online services and may fail to attract both advertisers and premium service subscribers.

We plan to expand operations in international markets in which we may have limited experience or rely on business partners, and in which we are faced with relatively higher costs.

We plan to expand Yahoo! branded online properties and search offerings in international markets. We have currently developed, through joint ventures, strategic investments, subsidiaries and branch offices, localized offerings in over 20 countries outside of the United States. As we expand into new international markets, we will have only limited experience in marketing and operating our products and services in such markets. In other instances, including our strategic investment in Alibaba, we may rely on the efforts and abilities of foreign business partners in such markets. We have experienced and expect to continue to experience higher costs as a percentage of revenues in connection with the development and maintenance of our international online properties relative to our domestic experience. Certain international markets may be slower than domestic markets in adopting the Internet as an advertising and commerce medium and so our operations in international markets may not develop at a rate that supports our level of investment.

In international markets we compete with local Internet service providers that may have competitive advantages.

In a number of international markets, especially those in Asia, Europe and Latin America, we face substantial competition from local Internet service providers and other portals that offer search, communications and other commercial services. Many of these companies have a dominant market share in their territories and are owned by local telecommunications providers which give them a competitive advantage. Local providers of competing online services may also have a substantial advantage over us in attracting users in their country due to more established branding in that country, greater knowledge with respect to the tastes and preferences of users residing in that country and/or their focus on a single market. Further, the local providers may have greater regulatory and operational flexibility than Yahoo! due to the fact that we are subject to both United States and foreign regulatory requirements. We must continue to improve our local offerings, become more knowledgeable about our local users and their preferences, deepen our relationships with our local users as well as increase our branding and other marketing activities in order to remain competitive and strengthen our international market position.

Our international operations are subject to increased risks which could harm our business, operating results and financial condition.

In addition to uncertainty about our ability to continue to generate revenues from our foreign operations and expand our international market position, there are certain risks inherent in doing business internationally, including:

- trade barriers and changes in trade regulations;
- difficulties in developing, staffing and simultaneously managing a large number of varying foreign operations as a result of distance, language and cultural differences;
- stringent local labor laws and regulations;
- longer payment cycles;
- currency exchange rate fluctuations;
- political or social unrest or economic instability;
- import or export restrictions;
- seasonal volatility in business activity;
- risks related to government regulation or required compliance with local laws in certain jurisdictions, including those more fully described above; and
- potentially adverse tax consequences.

One or more of these factors could harm our future international operations and consequently, could harm our brand, business, operating results and financial condition.

We may be subject to legal liability for online services.

We host a wide variety of services that enable individuals and businesses to exchange information, generate content, advertise products and services, conduct business and engage in various online activities on an international basis. The law relating to the liability of providers of these online services for activities of their users is currently unsettled both within the United States and internationally. Claims have been threatened and have been brought against us for defamation, negligence, copyright or trademark infringement, unlawful activity, tort, including personal injury, fraud, or other theories based on the nature and content of information that we provide links to or that may be posted online or generated by our users or with respect to auctioned materials. In addition, Yahoo! was the subject of a claim brought by certain entities in a French court regarding, among other things, the availability of certain content within our services which was alleged to violate French law. We may be subject to similar actions in domestic or other international jurisdictions in the future. Our defense of any such actions could be costly and involve significant time and attention of our management and other resources.

We also periodically enter into arrangements to offer third-party products, services or content under the Yahoo! brand or via distribution on the Yahoo! Properties, including stock quotes and trading information. We may be subject to claims concerning these products, services or content by virtue of our involvement in marketing, branding, broadcasting or providing access to them, even if we do not ourselves host, operate, provide, or provide access to these products, services or content. While our agreements with respect to these products, services and content, often provide that we will be indemnified against such liabilities, the ability to receive such indemnification depends on the financial resources of the other party to the agreement and any amounts received may not be adequate to cover our liabilities.

It is also possible that, if any information provided directly by us contains errors or is otherwise negligently provided to users, third parties could make claims against us. For example, we offer web-based e-mail

services, which expose us to potential risks, such as liabilities or claims resulting from unsolicited e-mail, lost or misdirected messages, illegal or fraudulent use of e-mail, or interruptions or delays in e-mail service. Investigating and defending any of these types of claims is expensive, even to the extent that the claims are without merit or do not ultimately result in liability.

We may have difficulty scaling and adapting our existing technology architecture to accommodate increased traffic and technology advances or requirements of our users and advertisers.

As one of the most highly trafficked websites on the Internet, Yahoo! delivers a growing number of products, services and page views to an increasing number of users around the world. In addition, the products and services offered by Yahoo! have expanded and changed significantly and are expected to continue to expand and change rapidly in the future to accommodate new technologies and new means of content delivery, such as rich media audio and video. Our future success will depend on our ability to adapt to rapidly changing technologies, to adapt our products and services to evolving industry standards and to improve the performance and reliability of our products and services. Rapid increases in the levels or types of use of our online properties and services could result in delays or interruptions in our service.

Widespread adoption of new Internet, networking or telecommunications technologies or other technological changes could require substantial expenditures to modify or adapt our services or infrastructure. The technology architectures utilized for our services are highly complex and may not provide satisfactory support in the future, as usage increases and products and services expand, change and become more complex. In the future, we may make significant changes to our architectures, including moving to completely new architectures and systems. Such changes may be technologically challenging to develop and implement, may cause us to incur substantial costs or data loss, and may cause users and advertisers to experience delays or interruptions in our service. These changes, delays or interruptions in our service may cause users and advertisers to become dissatisfied with our service and move to competing providers of online services. Further, to the extent that demands for our services increase, we will need to expand our infrastructure, including the capacity of our hardware servers and the sophistication of our software. This expansion is likely to be expensive and complex and require additional technical expertise. As we acquire users who rely upon us for a wide variety of services, it becomes more technologically complex and costly to retrieve, store and integrate data that will enable us to track each user's preferences. Any difficulties experienced in adapting our architectures and infrastructure to accommodate increased traffic, to store user data and track user preferences, together with the associated costs and potential loss of traffic, could harm our operating results, cash flows from operations and financial condition.

Our business depends on the continued growth and maintenance of the Internet infrastructure.

The success and the availability of our Internet-based products and services depends in part upon the continued growth and maintenance of the Internet infrastructure itself, including its protocols, architecture, network backbone, data capacity and security. Spam, viruses, worms, spyware, denial of service attacks and other acts of malice may affect not only the Internet's speed, reliability and availability but also its continued desirability as a vehicle for commerce, information and user engagement. If the Internet proves unable to meet the new threats and increased demands placed upon it, our business plans, user and advertiser relationships, site traffic and revenues could be adversely affected.

New technologies could block our advertisements or our search marketing listings, which would harm our operating results.

Technologies have been developed and are likely to continue to be developed that can block the display of our advertisements or our search marketing listings. Most of our revenues are derived from fees paid to us by advertisers in connection with the display of advertisements or our search marketing listings on web

pages. As a result, advertisement-blocking technology could reduce the number of advertisements and search results that we are able to deliver and, in turn, our advertising revenues and operating results.

We rely on third party providers for our principal Internet connections and technologies, databases and services critical to our properties and services, and any errors, failures or disruption in the services provided by these third parties could significantly harm our business and operating results.

We rely on private third-party providers for our principal Internet connections, co-location of a significant portion of our data servers and network access. Any disruption, from natural disasters, technology malfunctions, sabotage or other factors, in the Internet or network access or co-location services provided by these third-party providers or any failure of these third-party providers to handle current or higher volumes of use could significantly harm our business, operating results and financial condition. We have little control over these third-party providers, which increases our vulnerability to disruptions or problems with their services. Any financial difficulties experienced by our providers may have negative effects on our business, the nature and extent of which we cannot predict. We license technology and related databases from third parties for certain elements of our properties, including, among others, technology underlying the delivery of news, stock quotes and current financial information, chat services, street mapping and telephone listings, streaming capabilities and similar services. We have experienced and expect to continue to experience interruptions and delays in service and availability for such elements. We also rely on a third-party provider for key components of our e-mail service. Furthermore, we depend on hardware and software suppliers for prompt delivery, installation and service of servers and other equipment to deliver our services. Any errors, failures, interruptions or delays experienced in connection with these third-party technologies and information services could negatively impact our relationship with users and adversely affect our brand, our business and operating results.

We rely on distribution agreements and relationships with various third parties, and any failure to obtain or maintain such distribution relationships on reasonable terms could impair our ability to fully execute our business plan.

In addition to our relationships with Internet access providers, to increase traffic for our offerings and make them more available and attractive to advertisers and users, we have certain distribution agreements and informal relationships with operators of online networks and leading websites, software companies, electronics companies, and computer manufacturers. Depending on the distributor and the agreement, these distribution arrangements may not be exclusive and may only have a short term. Some of our distributors, particularly distributors who are also competitors or potential competitors, may not renew their distribution agreements with us. In addition, as new methods for accessing the Internet become available, including through alternative devices, we may need to enter into amended distributions agreements with existing distributors to cover the new devices and agreements with additional distributors. In the future, existing and potential distributors may not offer distribution of our properties and services to us on reasonable terms, or at all. If we fail to obtain distribution or to obtain distribution on terms that are reasonable, we may not be able to fully execute our business plan.

We rely on third party providers of streaming media products to stream audio and video content to our users, and any change in the licensing terms, costs, availability or user acceptance of these products could adversely affect our business.

We rely on leading providers of streaming media products to license the software necessary to stream audio and video content to our users. There can be no assurance that these providers will continue to license these products to us on reasonable terms, or at all. Our users are currently able to electronically download copies of the software to play streaming media free of charge, but providers of streaming media products may begin charging users for copies of their player software or otherwise change their business

model in a manner that slows the widespread acceptance of these products. In order for our rich media services to be successful, there must be a large base of users of these streaming media products. We have limited or no control over the availability or acceptance of streaming media software, and to the extent that any of these circumstances occur, our business may be adversely affected.

If we fail to detect click spam, we could lose the confidence of our advertisers, thereby causing a loss of advertisers and revenue.

We are exposed to the risk of clicks on our advertisements by persons seeking to increase the fees paid by our advertisers. Click spam may occur when a click is generated on one of our advertiser's listings displayed on a website in order to generate a payment rather than to view the underlying content. This type of activity could damage our brand. If click spam is not detected, the affected advertisers may perceive a reduced return on their investment in our advertising programs because those clicks will not lead to potential revenue for the advertisers. This could lead the advertisers to become dissatisfied with our advertising programs, which could lead to loss of advertisers and revenue. If this activity occurs and we are unable to stop it, we may have to provide refunds of revenue that our advertisers have paid to us and that was later attributed to click spam, in order to prevent damage to our brand.

Interruptions, delays or failures in the provision of our services could damage our brand and harm our operating results.

Our operations are susceptible to outages due to fire, floods, power loss, telecommunications failures, terrorist attacks and similar events. In addition, a significant portion of our network infrastructure is located in Northern California, an area subject to earthquakes. Despite our implementation of network security measures, our servers are vulnerable to computer viruses, worms, physical and electronic break-ins, sabotage and similar disruptions from unauthorized tampering with our computer systems. For example, we are vulnerable to coordinated attempts to overload our systems with data, resulting in denial or reduction of service to some or all of our users for a period of time. We have experienced a coordinated denial of service attack in the past, and may experience such attempts in the future. We do not have multiple site capacity for all of our services and some of our systems are not fully redundant in the event of any such occurrence. In an effort to reduce the likelihood of a geographical or other disaster impacting our business, we have distributed and intend to continue distributing our servers among additional data centers located around the world. Failure to execute these changes properly or in a timely manner could result in delays or interruptions to our service, which could result in a loss of users and damage to our brand, and harm our operating results. We may not carry sufficient business interruption insurance to compensate us for losses that may occur as a result of any events, which cause interruptions in our service.

We may be required to record a significant charge to earnings if our goodwill or amortizable intangible assets become impaired.

We are required under generally accepted accounting principles to review our amortizable intangible assets for impairment when events or changes in circumstances indicate the carrying value may not be recoverable. Goodwill is required to be tested for impairment at least annually. Factors that may be considered a change in circumstances indicating that the carrying value of our amortizable intangible assets may not be recoverable include a decline in stock price and market capitalization, and slower growth rates in our industry. We may be required to record a significant charge to earnings in our consolidated financial statements during the period in which any impairment of our goodwill or amortizable intangible assets is determined. This may adversely impact our results of operations.

Our stock price has been volatile historically and may continue to be volatile regardless of our operating performance.

The trading price of our common stock has been and may continue to be subject to wide fluctuations. During 2005, the closing sale prices of our common stock on the Nasdaq ranged from $30.87 to $42.50 per share and the closing sale price on February 28, 2006 was $32.06 per share. Our stock price may fluctuate in response to a number of events and factors, such as quarterly variations in operating results; announcements of technological innovations or new services and media properties by us or our competitors; changes in financial estimates and recommendations by securities analysts; the operating and stock price performance of other companies that investors may deem comparable to us; the operating performance of companies in which we have an equity investment, including Yahoo! Japan and Alibaba; the stock price of companies in which we have an equity investment, including Yahoo! Japan; and news reports relating to trends in our markets or general economic conditions.

In addition, the stock market in general, and the market prices for Internet-related companies in particular, have experienced volatility that often has been unrelated to the operating performance of such companies. These broad market and industry fluctuations may adversely affect the price of our stock, regardless of our operating performance. Additionally, volatility or a lack of positive performance in our stock price may adversely affect our ability to retain key employees, all of whom have been granted stock options or other equity-based awards.

Anti-takeover provisions could make it more difficult for a third party to acquire us.

We have adopted a stockholder rights plan and initially declared a dividend distribution of one right for each outstanding share of common stock to stockholders of record as of March 20, 2001. As a result of our two-for-one stock split effective May 11, 2004, each share of common stock is now associated with one-half of one right. Each right entitles the holder to purchase one unit consisting of one one-thousandth of a share of our Series A Junior Participating Preferred Stock for $250 per unit. Under certain circumstances, if a person or group acquires 15 percent or more of our outstanding common stock, holders of the rights (other than the person or group triggering their exercise) will be able to purchase, in exchange for the $250 exercise price, shares of our common stock or of any company into which we are merged having a value of $500. The rights expire on March 1, 2011, unless extended by our Board of Directors. Because the rights may substantially dilute the stock ownership of a person or group attempting to take us over without the approval of our Board of Directors, our rights plan could make it more difficult for a third party to acquire us (or a significant percentage of our outstanding capital stock) without first negotiating with our Board of Directors regarding that acquisition.

In addition, our Board of Directors has the authority to issue up to 10,000,000 shares of Preferred Stock (of which 2,000,000 shares have been designated as Series A Junior Participating Preferred Stock) and to determine the price, rights, preferences, privileges and restrictions, including voting rights, of those shares without any further vote or action by the stockholders.

The rights of the holders of our common stock may be subject to, and may be adversely affected by, the rights of the holders of any Preferred Stock that may be issued in the future. The issuance of Preferred Stock may have the effect of delaying, deterring or preventing a change of control of Yahoo! without further action by the stockholders and may adversely affect the voting and other rights of the holders of our common stock. Further, certain provisions of our charter documents, including provisions eliminating the ability of stockholders to take action by written consent and limiting the ability of stockholders to raise matters at a meeting of stockholders without giving advance notice, may have the effect of delaying or preventing changes in control or management of Yahoo!, which could have an adverse effect on the market price of our stock. In addition, our charter documents do not permit cumulative voting, which may make it more difficult for a third party to gain control of our Board of Directors. Further, we are subject

to the anti-takeover provisions of Section 203 of the Delaware General Corporation Law, which will prohibit us from engaging in a "business combination" with an "interested stockholder" for a period of three years after the date of the transaction in which the person became an interested stockholder, even if such combination is favored by a majority of stockholders, unless the business combination is approved in a prescribed manner. The application of Section 203 also could have the effect of delaying or preventing a change of control or management.

Item 1B. Unresolved Staff Comments

None.

Item 2. Properties

Our headquarters is located in Sunnyvale, California and consists of owned and leased space aggregating approximately 1 million square feet. Office space is also leased in Amsterdam, Bangalore, Buenos Aires, Calgary, Copenhagen, Dublin, Dusseldorf, Echirolles, Hamburg, Hong Kong, London, Oslo, Madrid, Melbourne, Mexico City, Milan, Montreal, Mumbai, Munich, New Delhi, Osaka, Paris, São Paulo, Seoul, Singapore, Stockholm, Sydney, Taipei, Tokyo, Toronto and Trondheim. We also lease offices in various locations in the United States, including Atlanta, Berkeley, Boston, Chicago, Columbus, Dallas, Detroit, Hillsboro, the Los Angeles Area, Miami, New York, Orlando, Reston, the San Diego Area, the San Francisco Bay Area, the Seattle Area, and Washington, D.C. Our datacenters are operated in locations in the United States, Europe and Asia.

We believe that our existing facilities are adequate to meet current requirements, and that suitable additional or substitute space will be available as needed to accommodate any further physical expansion of operations and for any additional sales offices.

Item 3. Legal Proceedings

From time to time, third parties assert patent infringement claims against Yahoo!. Currently, we are engaged in several lawsuits regarding patent issues and have been notified of a number of other potential patent disputes. In addition, from time to time we are subject to other legal proceedings and claims in the ordinary course of business, including claims of alleged infringement of trademarks, copyrights, trade secrets and other intellectual property rights, claims related to employment matters, and a variety of claims, including claims alleging defamation or invasion of privacy, arising in connection with our e-mail, message boards, auction sites, shopping services and other communications and community features.

On May 24, 2001, Arista Records, Inc., Bad Boy Records, BMG Music d/b/a The RCA Records Label, Capitol Records, Inc., Virgin Records America, Inc., Sony Music Entertainment, Inc., UMG Recordings, Inc., Interscope Records, Motown Record Company, L.P., and Zomba Recording Corporation filed a lawsuit alleging copyright infringement against LAUNCH in the United States District Court for the Southern District of New York. The plaintiffs allege, among other things, that the consumer-influenced portion of LAUNCH's LAUNCHcast service is "interactive" within the meaning of Section 114 of the Copyright Act and therefore does not qualify for the compulsory license provided for by the Copyright Act. The Complaint seeks declaratory and injunctive relief and damages for the alleged infringement. After the lawsuit was commenced, Yahoo! entered into an agreement to acquire LAUNCH. In June 2001, LAUNCH settled the LAUNCH litigation as to UMG Recordings, Inc. Our acquisition of LAUNCH closed in August 2001, and since that time LAUNCH has been a wholly owned subsidiary of Yahoo!. Yahoo! and LAUNCH do not believe that LAUNCH has infringed any rights of plaintiffs and intend to vigorously contest the lawsuit. In January 2003, LAUNCH settled the LAUNCH litigation as to Sony Music Entertainment, Inc. In October 2003, LAUNCH settled the litigation as to Capitol Records, Inc. and Virgin Records America, Inc. Accordingly, BMG Music d/b/a/ The RCA Records Label

is the sole remaining plaintiff in this proceeding. On March 16, 2004, the plaintiff filed motions for partial summary judgment on the issues of willful infringement and whether the consumer-influenced portion of LAUNCH'S LAUNCHcast service is "interactive" within the meaning of Section 114 of the Copyright Act and therefore does not qualify for the compulsory license provided for by the Copyright Act. LAUNCH filed its opposition to the motions for partial summary judgment on April 30, 2004, and a hearing on the motions was held on June 18, 2004. On November 4, 2005, the Court issued an order denying the plaintiff's summary judgment motions as to interactivity and willful infringement. A trial date is currently set for June 2006. We do not believe it is feasible to predict or determine the outcome or resolution of the remaining LAUNCH litigation at this time. The range of possible resolutions of such LAUNCH litigation could include judgments against LAUNCH or settlements that could require substantial payments by LAUNCH.

On July 12, 2001, the first of several purported securities class action lawsuits was filed in the United States District Court for the Southern District of New York against certain underwriters involved in Overture's initial public offering, Overture, and certain of Overture's current and former officers and directors. The Court consolidated the cases against Overture. Plaintiffs allege, among other things, violations of the Securities Act of 1933 and the Securities Exchange Act of 1934 involving undisclosed compensation to the underwriters, and improper practices by the underwriters, and seek unspecified damages. Similar complaints were filed in the same court against numerous public companies that conducted initial public offerings of their common stock since the mid-1990s. All of these lawsuits were consolidated for pretrial purposes before Judge Shira Scheindlin. On April 19, 2002, plaintiffs filed an amended complaint, alleging Rule 10b-5 claims of fraud. On July 15, 2002, the issuers filed a motion to dismiss for failure to comply with applicable pleading standards. On October 8, 2002, the Court entered an Order of Dismissal as to all of the individual defendants in the Overture IPO litigation, without prejudice. On February 19, 2003, the Court denied the motion to dismiss the Rule 10b-5 claims against certain defendants, including Overture. On August 31, 2005, the Court entered an order confirming its preliminary approval of a settlement proposal made by plaintiffs, which includes settlement of, and release of claims against, the issuer defendants, including Overture. A hearing on the fairness of the settlement to the shareholder class is currently set for April 24, 2006. If the settlement does not occur, and litigation against Overture continues, Yahoo! and Overture believe that Overture has meritorious defenses to liability and damages and will continue to defend the case vigorously.

We do not believe, based on current knowledge, that any of the foregoing legal proceedings or claims are likely to have a material adverse effect on our financial position, results of operations or cash flows. However, we may incur substantial expenses in defending against third party claims. In the event of a determination adverse to Yahoo! or its subsidiaries, we may incur substantial monetary liability, and be required to change our business practices. Either of these could have a material adverse effect on our financial position, results of operations or cash flows.

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

No matters were submitted to a vote of security holders during the fourth quarter of 2005.

Part II

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

Market Information for Common Stock

Yahoo! Inc. common stock is quoted on the Nasdaq National Market System under the symbol "YHOO." The following table sets forth the range of high and low per share sales prices as reported for each period indicated and reflects all stock splits effected:

	2004		2005	
	High	Low	High	Low
First quarter	$25.21	$20.57	$38.90	$30.30
Second quarter	$36.51	$23.95	$38.95	$32.29
Third quarter	$35.34	$25.52	$38.02	$31.60
Fourth quarter	$39.79	$33.60	$43.45	$32.77

Stockholders

We had 11,447 stockholders of record as of February 28, 2006.

Dividends

We have not declared or paid any cash dividends on our common stock. We presently intend to retain our future earnings, if any, to fund the development and growth of our business and, therefore, do not have plans to pay any cash dividends in the near future.

Recent Sales of Unregistered Securities

We did not make any unregistered sales of our common stock during the fourth quarter of 2005.

Issuer Purchases of Equity Securities

Stock repurchase activity during the three months ended December 31, 2005 was as follows:

Period	Total Number of Shares Purchased [1]	Average Price Paid per Share	Total Number of Shares Purchased as Part of a Publicly Announced Program	Approximate Dollar Value of Shares that May Yet be Purchased Under the Programs (in 000s) [1] [2]
October 1 – October 31, 2005	435,100	$33.05	435,100	$2,777,160
November 1 – November 30, 2005	—	—	—	$2,777,160
December 1 – December 31, 2005	—	—	—	$2,777,160
Total	435,100	$33.05	435,100	

(1) The shares repurchased in the three months ended December 31, 2005 were under our stock repurchase program that was announced in March 2005 with an authorized level of $3.0 billion. This program will expire in March 2010.

(2) As of December 31, 2005, we had unsettled structured stock transactions in the amount of $745 million. These transactions will mature in separate tranches in January, February, April, and May 2006. On each of the remaining maturity dates, if the market price of Yahoo! common stock is at or above $33.98 for the $250 million tranche maturing in January 2006, $38.66 for the $110 million tranche maturing in February 2006, $33.99 for the $250 million tranche maturing in April 2006, and $38.66 for the $135 million tranche maturing in May 2006, we will have our investments returned with a premium. On each of the remaining maturity dates, if the market price of our common stock is below such pre-determined prices, we will repurchase our common stock, up to an aggregate of 23.1 million shares. Any repurchases under these structured stock repurchase transactions will be reported in the quarter or quarters in which they occur. While outstanding, these structured stock repurchase transactions reduce the dollar value of additional shares that may be repurchased under our current program to approximately $2.0 billion as of December 31, 2005.

Item 6. Selected Financial Data

Consolidated Statements of Operations Data:

(in thousands, except per share amounts)	Years Ended December 31, 2001	2002	2003	2004	2005
Revenues	$ 717,422	$ 953,067	$1,625,097	$3,574,517	$5,257,668
Income (loss) from operations	$ (158,270)	$ 88,188	$ 295,666	$ 688,581	$1,107,725
Net income (loss) before cumulative effect of accounting change [1]	$ (92,788)	$ 106,935	$ 237,879	$ 839,553	$1,896,230
Cumulative effect of accounting change	—	(64,120)	—	—	—
Net income (loss) [1]	$ (92,788)	$ 42,815	$ 237,879	$ 839,553	$1,896,230
Net income (loss) per share before cumulative effect of accounting change — basic [1]	$ (0.08)	$ 0.09	$ 0.19	$ 0.62	$ 1.35
Cumulative effect of accounting change per share — basic	—	(0.05)	—	—	—
Net income (loss) per share — basic [1]	$ (0.08)	$ 0.04	$ 0.19	$ 0.62	$ 1.35
Net income (loss) per share before cumulative effect of accounting change — diluted [1]	$ (0.08)	$ 0.09	$ 0.18	$ 0.58	$ 1.28
Cumulative effect of accounting change per share — diluted	—	(0.05)	—	—	—
Net income (loss) per share — diluted [1]	$ (0.08)	$ 0.04	$ 0.18	$ 0.58	$ 1.28
Shares used in per share calculation — basic	1,139,448	1,187,677	1,233,480	1,353,439	1,400,421
Shares used in per share calculation — diluted	1,139,448	1,220,120	1,310,796	1,452,499	1,485,591

Consolidated Balance Sheets Data:

(in thousands)	December 31, 2001	2002	2003	2004	2005
Cash and cash equivalents	$ 333,886	$ 234,073	$ 415,892	$ 823,723	$ 1,429,693
Marketable debt securities	$1,138,107	$1,299,965	$2,150,323	$2,918,539	$ 2,570,155
Working capital	$ 693,016	$ 558,190	$1,013,913	$2,909,768	$ 2,245,481
Total assets	$2,379,346	$2,790,181	$5,931,654	$9,178,201	$10,831,834
Long-term liabilities	$ 23,806	$ 84,540	$ 822,890	$ 851,782	$ 1,061,367
Total stockholders' equity	$1,967,017	$2,262,270	$4,363,490	$7,101,446	$ 8,566,415

[1] Our net income for 2004 included gains related to sales of an investment of $314 million, net of tax, or $0.23 per basic share or $0.22 per diluted share. Our net income for 2005 included gains related to sales of an investment of $580 million, net of tax; a gain related to the divestiture of Yahoo! China in connection with the Alibaba transaction of $205 million, net of tax; and a tax benefit of $248 million related to a subsidiary restructuring transaction. In aggregate, these items had an impact of $1,033 million on net income, or $0.74 per basic share or $0.70 per diluted share.

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

Forward-Looking Statements

In addition to current and historical information, this Report contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements relate to our future operations, prospects, potential products, services, developments and business strategies. These statements can, in some cases, be identified by the use of terms such as "may," "will," "should," "could," "would," "intend," "expect," "plan," "anticipate," "believe," "estimate," "predict," "project," "potential," or "continue" or the negative of such terms or other comparable terminology. This Report includes, among others, forward-looking statements regarding our:

- expectations about revenues for marketing services and fees;
- expectations about growth in users;
- expectations about cost of revenues and operating expenses;
- expectations about effective tax rate;
- anticipated capital expenditures;
- evaluation of possible acquisitions of, or investments in, businesses, products and technologies; and
- expectations about positive cash flow generation and existing cash and investments being sufficient to meet normal operating requirements.

These statements involve certain known and unknown risks and uncertainties that could cause our actual results to differ materially from those expressed or implied in our forward-looking statements. Such risks and uncertainties include, among others, those listed in Part I Item 1A "Risk Factors" of this Annual Report on Form 10-K. We do not intend, and undertake no obligation, to update any of our forward-looking statements after the date of this Report to reflect actual results or future events or circumstances.

Overview

We are a leading global Internet brand and one of the most trafficked Internet destinations worldwide. We seek to provide Internet services that are essential and relevant to users and businesses. To users, we provide our owned and operated online properties and services (the "Yahoo! Properties"). To businesses, we provide a range of tools and marketing solutions designed to enable businesses to reach our community of users.

We offer a broad range and deep array of innovative products and services that are designed to provide our users with the power to connect, communicate, create, access, and share information online. We seek to provide efficient and effective marketing services for businesses to reach our community of users. Our focus is on engaging more deeply with users and increasing the user base on Yahoo! Properties, thereby enhancing value for our advertisers. We believe that we can increase our existing and potential user base and our users' engagement on Yahoo! Properties not only by offering compelling Internet services, but also by effectively integrating search, community, personalization and content to create a more powerful user experience.

We also focus on extending our marketing platform and access to Internet users beyond Yahoo! Properties through our distribution network of third party entities (referred to as "affiliates") who have integrated our search offerings into their websites.

Many of our services are free to users. We generate revenues by providing marketing services to businesses across a majority of our properties and by charging our users for premium services. We classify these revenues as either marketing services or fees. Our offerings to users and businesses currently fall into four categories — Search; Marketplace; Information and Entertainment; and Communications and Connected Life. The majority of our offerings are available globally in more than 15 languages. We manage and measure our business geographically. Our principal geographies are the United States and International.

Revenue Sources

Marketing Services Revenue. The majority of our marketing services revenue is from sales of online display advertising and is generated from several offerings including: the display of rich media advertisements, display of text based links to the advertiser's website, listing based services, and commerce based transactions.

We recognize revenue related to the display of advertisements on the Yahoo! Properties as "impressions" are delivered. An "impression" is delivered when an advertisement appears in pages viewed by users. We generate revenue from the display of text based links to the websites of our advertisers which are placed on the Yahoo! Properties and also on the websites of our affiliates who have integrated our search offerings into their websites. We recognize revenue from these arrangements as "click-throughs" occur. A "click-through" occurs when a user clicks on an advertiser's listing.

Marketing services revenue also includes listings revenue and transaction revenue. Listings revenue is generated from a variety of consumer and business listings-based services, including access to the Yahoo! HotJobs database and classifieds such as Yahoo! Autos, Yahoo! Real Estate and other services. We recognize listings revenue when the services are performed. Transaction revenue is generated from facilitating commerce transactions through the Yahoo! Properties, principally from Yahoo! Travel and Yahoo! Shopping. We recognize transaction revenue when there is evidence that qualifying transactions have occurred, for example, when travel arrangements are booked through Yahoo! Travel.

Fees Revenue. Fees revenue consists of revenues generated from a variety of consumer and business fee-based services, including Internet broadband services, premium mail, music and personals offerings, as well as services for small businesses. We recognize fees revenue when the services are performed.

Operating Highlights (in thousands)	Years ended December 31, 2004	2005	Year over Year Change
Revenues	$ 3,574,517	$5,257,668	$1,683,151
Income from operations	$ 688,581	$1,107,725	$ 419,144
Net cash provided by operating activities	$ 1,089,821	$1,711,383	$ 621,562
Net cash used in investing activities	$(1,292,849)	$ (821,930)	$ 470,919
Net cash provided by (used in) financing activities	$ 580,967	$ (250,600)	$ (831,567)

Our revenue growth can be attributed to a combination of organic growth and acquisitions. On an organic level, we are benefiting from an expanding user and advertiser base and from increased user activity levels across our offerings on the Yahoo! Properties. This revenue growth together with our overall effort to manage discretionary spending has led to the year over year increases in income from operations. We also continue to acquire companies. If an acquisition has a significant impact on our revenues and expenses, the revenues and expenses of our acquired business is described as "acquisition related" in the discussion that follows until the first anniversary of the acquisition date. Thereafter the underlying results of the acquired business are considered part of our organic base. Our historical financial statements reflect the impact of these acquired businesses from their respective dates of acquisition and the discussion of our results of operations that follows explains the material impact of these acquisitions, if any, on our consolidated results to provide information that will assist in understanding the changes in the years presented. Our year over year reported growth rates, calculated on a consolidated basis, include the impact from acquisitions. Excluding the impact from acquisitions, our growth rates would be lower.

Our revenue growth for the year ended December 31, 2005, compared to the prior year, can be attributed to an expanding user base and from increased user activity levels across our offerings on the Yahoo! Properties. The growth in our engaged audience, in terms of the number of users, paying users and activity levels on our properties, including an increasing number of page views, has attracted more advertisers to our advertising services and resulted in an increase in our revenues.

In addition, during 2005 we invested over $2.0 billion in significant acquisitions including business combinations, asset acquisitions and a strategic investment, predominantly internationally, which we believe will position us to benefit from the growing global online advertising market.

Cash generated from our operations is a measure of the cash productivity of our business model and is an area of focus for us. The growth of cash flow from operations is primarily driven by our increasing net income adjusted for non-cash items such as depreciation and amortization, tax benefits from stock options, as well as non operating gains or losses. In 2005, non operating gains included gains from sales of marketable equity securities and the divestiture of Yahoo! China in connection with the Alibaba transaction. Cash used in investing activities in 2005 included our cash consideration for acquisitions, including the strategic investment in Alibaba, offset by proceeds from sales of marketable equity securities. Cash used in financing activities in 2005 reflected our net cash used for direct stock repurchases and structured stock repurchase transactions offset by cash proceeds from the issuance of common stock as a result of the exercise of employee stock options.

During the year ended December 31, 2005, we recorded gains of approximately $987 million related to sales of non-strategic marketable equity securities, and a non-cash gain of $338 million related to the divestiture of Yahoo! China in connection with the Alibaba transaction. These gains of approximately $1.3 billion are included in other income, net in the consolidated statements of operations. Other income, net may fluctuate in future periods due to realized gains and losses on investments, impairments of investments, changes in our average investment balances, and changes in interest and foreign exchange rates.

The provision for income taxes for 2005 was $768 million and yielded an effective tax rate of 30 percent for 2005, compared to an effective tax rate of 37 percent for 2004 and 43 percent for 2003. The lower effective tax rate for 2005 was primarily a result of a tax benefit of approximately $248 million related to a subsidiary restructuring transaction completed during 2005. We currently expect our effective tax rate to increase in 2006 compared to 2005.

Summary

We believe the search queries, page views, click-throughs and the related marketing services and fees revenues that we generate are correlated to the number and activity level of users across our offerings on the Yahoo! Properties. By providing a platform for our users that brings together our search technology, content, and community while allowing for personalization and integration across devices, we seek to become more essential to, increase our share of, and deepen the engagement of, our users with our products and services. We believe this deeper engagement of new and existing users, coupled with the growth of the Internet as an advertising medium will increase our revenues in 2006.

In the following Management's Discussion and Analysis, we discuss the following areas of our financial results:

- Results of Operations;
- Business Segment Results;
- Acquisitions;
- Liquidity and Capital Resources;
- Critical Accounting Policies, Judgments and Estimates; and
- Recent Accounting Pronouncements.

Results of Operations

The following table sets forth selected information on our results of operations as a percentage of revenues for the periods indicated:

	Years Ended December 31,		
	2003	2004	2005
Revenues	100%	100%	100%
Cost of revenues	23	38	40
Gross profit	77	62	60
Operating expenses:			
Sales and marketing	33	22	20
Product development	13	10	10
General and administrative	10	7	6
Stock compensation expense	1	1	1
Amortization of intangibles	2	3	2
Total operating expenses	59	43	39
Income from operations	18	19	21
Other income, net	3	14	27
Income before income taxes, earnings in equity interests, and minority interests	21	33	48
Provision for income taxes	(9)	(12)	(14)
Earnings in equity interests	3	2	2
Minority interests in operations of consolidated subsidiaries	0	0	0
Net income	15%	23%	36%

Revenues. Revenues by groups of similar services were as follows (dollars in thousands):

	Years Ended December 31,						2003-2004	2004-2005
	2003	(1)	2004	(1)	2005	(1)	% Change	% Change
Marketing services [2]	$1,321,938	81%	$3,127,229	87%	$4,593,972	87%	137%	47%
Fees [2]	303,159	19%	447,288	13%	663,696	13%	48%	48%
Total revenues	$1,625,097	100%	$3,574,517	100%	$5,257,668	100%	120%	47%

(1) Percent of total revenues.

(2) We reclassified previously reported marketing services revenue of $5 million and $22 million, respectively, as fees revenue for the years ended December 31, 2003 and 2004 in order to refine the alignment of revenue sources with current year classifications.

Marketing Services Revenue. Marketing services revenue for the year ended December 31, 2005 increased by approximately $1,467 million, or 47 percent, as compared to the prior year. The year over year growth in our marketing services revenue was primarily organic and can be attributed to a combination of factors that are driving higher advertising revenue across all of the Yahoo! Properties. We experienced an increase in our user base and activity levels on the Yahoo! Properties, which resulted in a higher volume of search queries, page views, and click-throughs. We believe our increased user audience attracted new advertisers to our portfolio of marketing solutions and contributed to the increase in our marketing services revenue over the prior year. Marketing services revenue for the year ended December 31, 2004 increased by approximately $1,805 million, or 137 percent, as compared to 2003. The growth in our marketing services revenue can be attributed to a combination of acquisitions and organic growth. Incremental revenue from acquisitions contributed approximately $1,230 million to the increase in the year ended December 31, 2004. The remainder of the increase, approximately $575 million in 2004 was from organic growth in advertising across the Yahoo! Properties as our user base increased.

On the Yahoo! Properties, our estimated number of unique users worldwide as of December 31, 2005 was approximately 6 percent higher than the number of unique users as of December 31, 2004, which was 31 percent higher than December 31, 2003. Unique users are the estimated number of people who visited the Yahoo! Properties in a given time period. The unique user estimate as of December 31, 2005 does not include the unique users of Yahoo! China as it was divested in October 2005 in connection with our strategic investment in Alibaba. If the unique users of Yahoo! China had been excluded as of December 31, 2004, our estimated unique users as of December 31, 2005 would have been 21 percent higher than as of December 31, 2004.

The combined number of page views and searches, including those from our affiliate network, increased by approximately 40 percent in 2005 as compared to the prior year. This growth was primarily organic. The combined number of page views and searches in 2004, including those from our affiliate network increased by approximately 50 percent as compared to 2003, with approximately 10 percent of the increase in volume attributable to acquisitions. The increases in the organic volume of page views and searches can be attributed to an increased number of users, an increased number of affiliates, an expanded offering of properties which increased our inventory of page views, and greater market acceptance of our search offerings. The combined average revenue per page view and search increased by approximately 5 percent in 2005 compared to 2004. This growth was primarily organic. The combined average revenue per page view and search increased by approximately 55 percent in 2004 compared to 2003, of which approximately one-half was attributable to acquisitions. Our combined revenue per page view and search was impacted by sales mix changes from period to period as we expanded our offerings on the Yahoo! Properties and introduced new inventory with differing yields.

We believe our growing number of users, advertisers and inventory has been driving this growth in our marketing services revenues. We believe our expanding offerings as well as our enhanced algorithmic search technology, which provides a new level of personalization to the search experience, contribute to our growing number of users. As our user base increases, we generate a higher number of page views, which we view as inventory, and process a higher number of search queries which potentially result in a higher number of impressions and paid clicks. We also believe that our growing user base makes the Yahoo! Properties more attractive to advertisers and increases their spending on marketing solutions. Further, we believe the growth in users on the Yahoo! Properties and on the Internet overall reflects the increasing acceptance, importance and dependence of users on the Internet. As a result of the increasing online audience, we believe advertisers are shifting a greater percentage of their spending from traditional media to the Internet to reach this growing audience.

Fees Revenue. For the year ended December 31, 2005, fees revenue increased approximately $216 million, or 48 percent, as compared to the prior year. Approximately $46 million of the increase was attributable to acquisitions and $147 million of the increase was associated with an increase in the number of paying users for our fee-based services, which numbered 12.6 million as of December 31, 2005 compared to 8.4 million as of December 31, 2004. Our increased base of paying users was due to growth in users across most of our offerings, with the largest growth generated from new Internet broadband users in the year. Our fee-based services include Internet broadband services, sports, music, personals, and premium mail offerings, as well as our services for small businesses. Average monthly revenue per paying user has remained consistent at approximately $4 in 2005 and 2004.

For the year ended December 31, 2004, fees revenue increased approximately $144 million, or 48 percent, as compared to 2003 of which $10 million related to acquisitions. Approximately $115 million was associated with an increase in the number of paying users for our fee-based services, which were 8.4 million as of December 31, 2004 compared to 4.9 million as of December 31, 2003. Our increasing base of paying users was due to a greater penetration of our services with our existing users as well as our continued expansion of service offerings that took place during the year, including new business relationships with BT and Rogers for fee-based services. Average monthly revenue per paying user per month declined to

approximately $4 in 2004 from $5 in 2003 due to faster subscriber growth in some of our lower priced offerings, and the introduction of lower priced fee-based services.

We currently expect marketing services revenue to increase in absolute dollars for 2006 compared to 2005 as we seek to increase users and traffic on our Yahoo! Properties and further benefit from expected growth in the online advertising market. We also currently expect fees revenue to increase in absolute dollars for 2006 compared to 2005 as we expect to increase our number of paying users in 2006.

Costs and Expenses: Operating costs and expenses were as follows (dollars in thousands):

	Years Ended December 31,						2003-2004	2004-2005
	2003	(1)	2004	(1)	2005	(1)	% Change	% Change
Cost of revenues	$370,092	23%	$1,342,338	38%	$2,096,201	40%	263%	56%
Sales and marketing	$530,613	33%	$ 778,029	22%	$1,025,249	20%	47%	32%
Product development	$207,285	13%	$ 368,760	10%	$ 547,137	10%	78%	48%
General and administrative	$157,027	10%	$ 262,602	7%	$ 319,690	6%	67%	22%
Stock compensation expense	$ 22,029	1%	$ 32,290	1%	$ 52,471	1%	47%	62%
Amortization of intangibles	$ 42,385	2%	$ 101,917	3%	$ 109,195	2%	140%	7%

(1) Percent of total revenues.

Cost of Revenues. Cost of revenues consists of traffic acquisition costs and other expenses associated with the production and usage of the Yahoo! Properties, including amortization of developed technology and patents.

Traffic Acquisition Costs ("TAC"). TAC consists of payments made to affiliates that have integrated our search offerings into their websites and payments made to companies that direct consumer and business traffic to the Yahoo! Properties. We enter into agreements of varying duration that involve TAC. There are generally three economic structures of the affiliate agreements: fixed payments based on a guaranteed minimum amount of traffic delivered, which often carry reciprocal performance guarantees from the affiliate; variable payments based on a percentage of our revenue or based on a certain metric, such as number of searches or paid clicks; or a combination of the two. We expense TAC under two different methods. Agreements with fixed payments are expensed ratably over the term the fixed payment covers, and agreements based on a percentage of revenue, number of paid introductions, number of searches, or other metrics are expensed based on the volume of the underlying activity or revenue multiplied by the agreed-upon price or rate.

Other Cost of Revenues. Other cost of revenues consists of fees paid to third parties for content included on our online media properties, Internet connection charges, data center costs, server equipment depreciation, technology license fees, amortization of developed technology and patents, and compensation related expenses.

Cost of revenues were as follows (dollars in thousands):

	Years Ended December 31,						2003-2004	2004-2005
	2003	(1)	2004	(1)	2005	(1)	% Change	% Change
TAC	$152,583	9%	$ 974,814	27%	$1,561,737	30%	539%	60%
Other cost of revenues	217,509	14%	367,524	11%	534,464	10%	69%	45%
Cost of revenues	$370,092	23%	$1,342,338	38%	$2,096,201	40%	263%	56%

(1) Percent of total revenues.

Cost of revenues for the year ended December 31, 2005 increased approximately $754 million, or 56 percent, compared to the prior year. The increase included $587 million of additional TAC, which represents the largest component of cost of revenues, as well as an increase of $64 million in content costs,

$39 million in depreciation expense, $27 million in Internet connection charges and data center costs, and $20 million in amortization of developed technology and patents. This year over year increase in TAC of 60 percent was driven by our 47 percent growth in marketing services revenue, higher average TAC rates and a product mix change toward revenue streams that have associated TAC. The increase in content costs was primarily from our expanded offerings some of which required content for new and enhanced services on Yahoo! Properties including music, sports, and games. The increase in depreciation expense and data center costs primarily resulted from the depreciation of additional information technology assets and data center costs required to manage our increasing user base, traffic, and new offerings on Yahoo! Properties. The increase in the amortization of developed technology and patents resulted from our continued acquisition activity.

Cost of revenues for the year ended December 31, 2004 increased approximately $972 million, or 263 percent, as compared to 2003. This reflected approximately $769 million of incremental cost of revenue related to acquisitions of which $703 million related to TAC associated with the Overture acquisition, and a $32 million increase in the amortization of technology and patents. The remainder of the increase represented increased costs for search serving, royalties and content, as well as increased costs for growing network usage and premium services.

Cost of revenues in 2005, 2004, and 2003 were 40 percent, 38 percent, and 23 percent of revenues, respectively. The year over year increases mainly related to the additional TAC described above.

We currently believe that cost of revenues will continue to increase in absolute dollars in 2006 compared to 2005. TAC, which is the largest component of our cost of revenues, is expected to increase as our marketing services revenue increases and as TAC rates increase in the competitive search market. Additionally, we expect to continue to increase our user base and offerings, which drive network usage and in turn higher Internet connection charges and data center costs. Further, we expect higher costs related to the introduction of additional content for new and enhanced services.

Sales and Marketing. Sales and marketing expenses consist primarily of advertising and other marketing related expenses, compensation related expenses, sales commissions and travel costs.

Sales and marketing expenses for the year ended December 31, 2005, increased approximately $247 million, or 32 percent, as compared to the prior year. Approximately $142 million of the increase was related to compensation expense as we increased our sales and marketing headcount to expand our presence in certain territories to service our expanding advertising business as well as support our growing advertiser base in existing regions. Additionally, year over year spending on marketing and distribution increased by $56 million, as we continued to invest in product branding and further develop our distribution channels. Sales and marketing expenses for the year ended December 31, 2004, increased approximately $247 million, or 47 percent, as compared to 2003. Sales and marketing expenses increased by approximately $136 million due to incremental costs related to acquisitions. The remainder of the increase was primarily due to increases of $25 million in marketing spending and $77 million in compensation and outside services expenses as we expanded our sales coverage model and increased our advertiser base and presence in certain territories.

Sales and marketing expenses in 2005, 2004, and 2003 as a percentage of revenues were 20 percent, 22 percent, and 33 percent, respectively, and decreased as a result of the overall increase in revenues, and savings as a result of our overall effort to manage discretionary costs.

We currently believe that sales and marketing expenses will increase in absolute dollars in 2006 compared to 2005, as we continue to grow and expand our reach to advertisers and users.

Product Development. Product development expenses consist primarily of compensation related expenses incurred for enhancements to and maintenance of the Yahoo! Properties, classification and

organization of listings within Yahoo! Properties and research and development, as well as depreciation expense and other operating costs.

Product development expenses for the year ended December 31, 2005 increased approximately $178 million, or 48 percent, as compared to the prior year. Approximately $121 million related to increased compensation expense as we continued to hire engineers to further develop and create new offerings and services on the Yahoo! Properties. Additionally, approximately $22 million of the increase related to higher depreciation expense arising from our additional investments in property and equipment to support further product development, and $23 million related to the increase in supplies and equipment related expenses required to support our growing headcount. Product development expenses for the year ended December 31, 2004, increased approximately $161 million, or 78 percent, as compared to 2003. Product development expenses increased by approximately $104 million due to incremental costs related to acquisitions. The majority of the remainder of the increase was due to increases of $34 million of compensation related expenses and $14 million of depreciation expense.

Product development expenses in 2005, 2004, and 2003 as a percentage of revenues were 10 percent, 10 percent, and 13 percent, respectively, and decreased as a result of the overall increase in revenues and savings as a result of our overall effort to manage discretionary costs.

We currently believe that product development expenses will increase in absolute dollars in 2006 compared to 2005, as we believe that continued investments in product development are required to remain competitive.

General and Administrative. General and administrative expenses consist primarily of compensation related expenses and fees for professional services.

General and administrative expenses for the year ended December 31, 2005 increased approximately $57 million, or 22 percent, as compared to the prior year. The increase was primarily due to a $48 million increase in outside services and compensation related expenses, which related to the expansion of our team to support growing compliance and infrastructure needs. General and administrative expenses for the year ended December 31, 2004 increased approximately $106 million, or 67 percent, as compared to 2003. General and administrative expenses increased by approximately $66 million due to incremental costs related to acquisitions. The remainder of the increase was primarily due to an increase of $24 million of professional services expenses and $16 million in compensation related expenses. Similar to the increase in 2005, the year over year increase in 2004 in compensation related expense reflected expansion of our team in line with, and to support, increased compliance and infrastructure needs.

General and administrative expenses as a percentage of revenues were 6 percent, 7 percent, and 10 percent in 2005, 2004, and 2003, respectively. The decrease is a result of the overall increase in revenues and savings as a result of our overall effort to manage discretionary costs.

We currently believe that general and administrative expenses in absolute dollars will increase in 2006 compared to 2005, as we continue to invest in our infrastructure to support our continued business expansion.

Stock Compensation. Stock compensation expense relates to the amortization of the intrinsic value of Yahoo! stock options issued and assumed in connection with business combinations and other equity-based awards that we issued. This expense is generally being amortized using the accelerated amortization method in accordance with Financial Accounting Standards Board ("FASB") Interpretation No. 28 "Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans."

The increase in stock compensation expense for the year ended December 31, 2005, was primarily a result of the amortization expense of newly issued equity-based awards partially offset by decreased costs associated with options assumed in acquisitions. The amortization of options assumed in acquisitions has

declined as the accelerated amortization method results in declining amortization of awards over their vesting periods and as we have not assumed a significant amount of options in our recent acquisitions. The increase in stock compensation expense for the year ended December 31, 2004, was primarily a result of a full year of amortization expense relating to stock options assumed in acquisitions, as well as an increase in the issuance of equity-based awards during the year. Stock compensation expense was allocated as follows (in thousands):

	Years Ended December 31,		
	2003	2004	2005
Sales and marketing	$ 5,785	$ 9,620	$ 8,698
Product development	10,526	12,010	22,390
General and administrative	5,718	10,660	21,383
Total stock compensation expense	$22,029	$32,290	$52,471

Our stock compensation expense in absolute dollars will increase significantly in 2006 compared to 2005. We currently expect that the stock compensation expense associated with the adoption of Statement of Financial Accounting Standards ("SFAS") No. 123R, ("SFAS 123R"), "Share-Based Payment" on January 1, 2006 will result in a reduction of income before income taxes, earnings in equity interests and minority interests in 2006 of approximately $420-$450 million. This expense will be allocated to and included in our functional operating expense line items and no longer included in a single line on our consolidated statements of operations. See "Recent Accounting Pronouncements" for further discussion regarding the impact of the adoption of SFAS 123R.

Amortization of Intangibles. We have purchased, and expect to continue purchasing, assets or businesses, which may include the purchase of intangible assets. Amortization of developed technology and patents is included in the cost of revenues.

Amortization of other intangibles was approximately $109 million, or 2 percent of revenues for the year ended December 31, 2005, compared to $102 million or 3 percent of revenues for 2004 and $42 million or 2 percent of revenues for 2003. The year over year increases in amortization of intangibles were the result of our continued acquisition activity which has resulted in increased amortizable intangible assets. As of December 31, 2005, we had net amortizable intangible assets of $535 million on our consolidated balance sheets.

Other Income, Net. Other income, net was as follows (in thousands):

	Years Ended December 31,		
	2003	2004	2005
Interest and investment income	$47,202	$ 60,830	$ 125,122
Investment gains (losses), net	(1,223)	415,125	967,327
Gain on divestiture of Yahoo! China	—	—	337,965
Other	1,527	20,488	5,443
Total other income, net	$47,506	$496,443	$1,435,857

Other income, net for the year ended December 31, 2005 included a non-cash gain of $338 million from the divestiture of Yahoo! China in connection with the Alibaba transaction. We also generated investment gains of approximately $987 million from sales of non-strategic marketable equity securities offset by an impairment loss of $28 million on an available-for-sale investment, compared to an investment gain of $413 million, net of selling costs from the sale of non-strategic marketable equity securities in 2004. In addition, interest and investment income earned in 2005 was higher than 2004 and 2003 as a result of larger average invested balances and higher average interest rates. Average interest rates were approximately 2.9 percent, 2.1 percent, and 2.4 percent in 2005, 2004, and 2003, respectively. Other

income, net may fluctuate in future periods due to realized gains and losses on investments, impairments of investments, changes in our average investment balances, and changes in interest and foreign exchange rates.

Income Taxes. The provision for income taxes for 2005, 2004, and 2003 differs from the amount computed by applying the federal statutory income tax rate due to state taxes and foreign losses for which no tax benefit was provided. Additionally, in 2005, the provision for income taxes reflects a tax benefit related to a subsidiary restructuring transaction. In 2004, the provision for income taxes reflects utilization of previously unbenefited capital losses.

The following table summarizes the differences between our provision for income taxes and the amount computed by applying the federal statutory income tax rate to income before income taxes (dollars in thousands):

	Years Ended December 31,					
	2003	(1)	2004	(1)	2005	(1)
Income tax at the United States federal statutory rate of 35 percent	$120,112	35%	$414,758	35%	$ 890,254	35%
State income taxes, net of federal benefit	15,184	4%	49,920	4%	113,685	4%
Change in valuation allowance	8,516	3%	(40,612)	(3%)	16,342	1%
Capital loss on subsidiary restructuring transaction	—	—	—	—	(248,284)	(10%)
Other	3,212	1%	13,900	1%	(4,181)	—
Provision for income taxes	$147,024	43%	$437,966	37%	$ 767,816	30%

(1) Percent of income before income taxes, earnings in equity interests and minority interests.

Our effective tax rate for the year ended December 31, 2005 was 30 percent compared to 37 percent in the prior year. The decreased rate was mainly attributable to the tax benefit related to a subsidiary restructuring transaction. During 2005, as part of our ongoing efforts to streamline our operational structure, we completed a taxable liquidation of a subsidiary we acquired several years ago. This transaction gave rise to a capital loss for tax purposes, which offset a substantial portion of the gains from sales of equity investments during the year. The resulting tax benefit was approximately $248 million. Our effective tax rate for the year ended December 31, 2004 was 37 percent compared to 43 percent in 2003. The decreased rate resulted primarily from a reduction of $41 million to the valuation allowance for 2004 compared to an increase of $9 million for 2003. The change in valuation allowance from 2003 to 2004 was driven primarily by our ability to utilize previously realized capital losses against the capital gain realized on the sale of an investment during 2004.

We currently expect our effective tax rate to increase in 2006 compared to 2005.

Earnings in Equity Interests. Earnings in equity interests were approximately $128 million for the year ended December 31, 2005 compared to $95 million in 2004 and $48 million in 2003, as a result of our investment in Yahoo! Japan. On October 23, 2005, we acquired approximately 46 percent of the outstanding common stock of Alibaba, or approximately 40 percent on a fully diluted basis. We account for this investment using the equity method of accounting. Following the acquisition date, we will record our share of the results of Alibaba, and any related amortization expense relating to the acquired intangible assets, one quarter in arrears within earnings in equity interests. See Note 4 — "Investments in Equity Interests" in the consolidated financial statements for additional information.

Minority Interests in Operations of Consolidated Subsidiaries. Minority interests in operations of consolidated subsidiaries represents the minority holders' percentage share of income or losses from such subsidiaries in which we hold a majority ownership interest, but less than 100 percent, and consolidate the

subsidiaries' results in our financial statements. Minority interests in income from operations of consolidated subsidiaries was approximately $8 million, $2 million, and $6 million for 2005, 2004, and 2003, respectively. On November 23, 2005, we purchased the remaining outstanding shares of Yahoo! Europe and Yahoo! Korea. Upon completion of this transaction, all of our consolidated subsidiaries were wholly-owned by us and as a result we had no minority interest liability as of December 31, 2005. See Note 3 — "Acquisitions" and Note 17 — "Subsequent Events" in the consolidated financial statements for additional information.

Business Segment Results

We manage our business geographically. Our primary areas of measurement and decision-making are the United States and International. Management relies on an internal management reporting process that provides revenue and segment operating income before depreciation and amortization for making financial decisions and allocating resources. Segment operating income before depreciation and amortization includes income from operations before depreciation, amortization of intangible assets and amortization of stock compensation expense. Management believes that segment operating income before depreciation and amortization is an appropriate measure for evaluating the operational performance of our segments. However, this measure should be considered in addition to, not as a substitute for, or superior to, income from operations or other measures of financial performance prepared in accordance with generally accepted accounting principles.

Summarized information by segment was as follows (dollars in thousands):

	Years Ended December 31,						2003-2004	2004-2005
	2003	(1)	2004	(1)	2005	(1)	% Change	% Change
Revenues by segment:								
United States	$1,355,153	83%	$2,653,437	74%	$3,667,509	70%	96%	38%
International	269,944	17%	921,080	26%	1,590,159	30%	241%	73%
Total revenues	$1,625,097	100%	$3,574,517	100%	$5,257,668	100%	120%	47%

(1) Percent of total revenues.

	Years Ended December 31,			2003-2004	2004-2005
	2003	2004	2005	% Change	% Change
Segment operating income before depreciation and amortization:					
United States	$ 441,372	$ 891,103	$1,219,539	102%	37%
International	36,011	140,809	337,799	291%	140%
Total segment operating income before depreciation and amortization	477,383	1,031,912	1,557,338	116%	51%
Depreciation and amortization	(159,688)	(311,041)	(397,142)	95%	28%
Stock compensation expense	(22,029)	(32,290)	(52,471)	47%	62%
Income from operations	$ 295,666	$ 688,581	$1,107,725	133%	61%

Revenue is attributed to individual countries according to the international online property that generated the revenue. No single foreign country accounted for more than 10 percent of revenues in 2005, 2004, or 2003.

United States. United States revenues in 2005 increased approximately $1,014 million, or 38 percent, as compared to the prior year. The increase is a result of strong organic growth in advertising across the Yahoo! Properties as well as growth from our fee-based services. Approximately 82 percent of the increase, or $827 million, came from marketing services revenue. The advertising growth can be attributed to our expanding user base which has been attracting more advertisers and has led to increases in our marketing services revenue. The growth in our fee-based services is due to the increase in our paying users for both existing and expanded offerings. United States revenues in 2004 increased approximately $1,298 million, or 96 percent, as compared to 2003. The year over year growth was due to a combination of acquisitions and organic growth. Incremental revenue from acquisitions contributed approximately $790 million to the increase in 2004. The remainder of the increase of $508 million in 2004 is primarily from strong growth in advertising across the Yahoo! Properties. United States segment operating income before depreciation and amortization increased approximately $328 million, or 37 percent from 2004 to 2005 and $450 million, or 102 percent from 2003 to 2004. The successive year over year increases are primarily a result of the increased revenues.

International. International revenues in 2005 increased approximately $669 million, or 73 percent, as compared to the prior year. More than 95 percent of the international revenue increase came from marketing services revenue in 2005. The year over year growth in international marketing services revenue can be attributed to our continued expansion into new markets and increased penetration into existing markets, coupled with continued growth of the global online advertising marketplace and our affiliate network. International revenues in 2004 increased approximately $651 million, or 241 percent, as compared to 2003. The year over year growth can be attributed to a combination of acquisitions and organic growth. Incremental revenue from acquisitions contributed approximately $449 million to the increase and the remainder of the increase, approximately $202 million is primarily from strong growth in advertising across the Yahoo! Properties and the strengthening of the Asian and European markets in which we primarily operate. International segment operating income before depreciation and amortization increased approximately $197 million, or 140 percent, from 2004 to 2005, primarily as a result of the increase in revenues and profit margin due to our continued efforts to control discretionary spending and our ability to generate revenue without a commensurate increase in costs. International segment operating income before depreciation and amortization increased approximately $105 million from 2003 to 2004, primarily due to the increase in revenues and continued efforts to control discretionary spending.

International revenues accounted for approximately 30 percent of total revenues during 2005 as compared to 26 percent during 2004 and 17 percent during 2003. The growth in our international operations has increased our exposure to foreign currency fluctuations. Revenues and related expenses generated from our international subsidiaries are generally denominated in the functional currencies of the local countries. Primary currencies include Euros, British Pounds, Japanese Yen, Korean Won, and Australian Dollars. The statements of operations of our international operations are translated into United States dollars at the average exchange rates in each applicable period. To the extent the United States dollar strengthens against foreign currencies, the translation of these foreign currency denominated transactions results in reduced revenues, operating expenses and net income for our International segment. Similarly, our revenues, operating expenses and net income will increase for our International segment if the United States dollar weakens against foreign currencies. Using the average foreign currency exchange rates from 2004, our international revenues for 2005 would have been lower than we reported by approximately $42 million and our international segment operating income before depreciation and amortization would have been lower that we reported by $8 million. Using the average foreign currency exchange rates from 2003, our international revenues for 2004 would have been lower than we reported by approximately $59 million and our international segment operating income before depreciation and amortization would have been lower than we reported by $10 million.

Acquisitions

Significant acquisitions and strategic investments completed in the last three years include the following:

- March 2003 — Inktomi, a provider of Internet search and paid inclusion services for a total purchase price of $290 million;
- October 2003 — Overture, a provider of commercial search services including sponsored search services for a total purchase price of $1.7 billion;
- January 2004 — 3721, a Hong Kong-based software development company focused on keyword search technology for a total purchase price of $95 million. In October 2005, we subsequently divested 3721 as part of Yahoo! China which was partial consideration for our investment in Alibaba;
- April 2004 — Kelkoo, a European online comparison shopping service for a total purchase price of $571 million;
- October 2004 — Musicmatch, a provider of personalized music software and services for a total purchase price of $158 million;
- February 2005 — Verdisoft, a software development company for a total purchase price of $58 million as well as restricted stock valued at $35 million;
- October 2005 — Strategic investment of approximately 46 percent (40 percent on a fully diluted basis) of the outstanding common stock of Alibaba, an e-commerce company based in China in exchange for $1.0 billion in cash and the contribution of Yahoo! China; and
- November 2005 — Purchase of the remaining outstanding shares of Yahoo! Europe and Yahoo! Korea for a total purchase price of $501 million.

See Note 3 — "Acquisitions" in the consolidated financial statements for additional information relating to these and other acquisitions.

We expect to continue to evaluate possible acquisitions of, or strategic investments in, businesses, products, and technologies that are complementary to our business, which may require the use of cash.

Liquidity and Capital Resources

As of and for the years ended December 31, (dollars in thousands):

	2003	2004	2005
Cash and cash equivalents	$ 415,892	$ 823,723	$1,429,693
Marketable debt securities	2,150,323	2,918,539	2,570,155
Total cash, cash equivalents, and marketable debt securities	$2,566,215	$3,742,262	$3,999,848
Percentage of total assets	43%	41%	37%

	2003	2004	2005
Net cash provided by operating activities	$ 428,144	$ 1,089,821	$1,711,383
Net cash used in investing activities	$(1,342,337)	$(1,292,849)	$ (821,930)
Net cash provided by (used in) financing activities	$ 1,086,326	$ 580,967	$ (250,600)

Our operating activities for each year in the three years ended December 31, 2005 have generated adequate cash to meet our operating needs. As of December 31, 2005, we had cash, cash equivalents and marketable debt securities totaling $4.0 billion, an increase of $258 million compared to $3.7 billion as of December 31, 2004. The principal components of the increase were cash generated from operating

activities of approximately $1.7 billion, proceeds of $1.0 billion from sales of marketable equity securities and proceeds of $747 million from the exercise of employee stock options, offset by cash used for acquisitions and a strategic investment of $1.7 billion, net cash used in structured stock repurchases activities of $611 million, $388 million used for direct stock repurchases, and net capital expenditures of $409 million.

As of December 31, 2005, approximately $45 million of earnings held by our foreign subsidiaries are designated as indefinitely invested outside the United States. If these funds were required for our operations in the United States, we would be required to accrue and pay additional taxes to repatriate these funds. Currently, we do not anticipate a need to repatriate these funds to our United States operations.

We invest excess cash predominantly in marketable debt securities that are liquid, of high-quality investment grade, and the majority of which have effective maturities of less than two years. We also invest excess cash to support our growing infrastructure needs and expand our operations, as consideration for acquisitions, to repurchase shares of our stock and in other transactions. As of December 31, 2005, certain of our marketable debt securities had a fair value below cost due to the changes in market rates of interest and yields on these securities. We evaluate these investments periodically for possible other-than-temporary impairment and review factors such as the length of time and extent to which fair value has been below cost basis, the financial condition of the issuer, and our ability and intent to hold the investment for a period of time which may be sufficient for an anticipated recovery in market value. We have the intent and ability to hold these securities for a reasonable period of time sufficient for a forecasted recovery of fair value up to (or beyond) the initial cost of the investment and expect to realize the full value of all of these investments upon maturity or sale.

We expect to continue to generate positive cash flow from operations in 2006. Management believes existing cash, cash equivalents and investments in marketable debt securities, together with any cash generated from operations will be sufficient to meet normal operating requirements including capital expenditures for the next 12 months. However, we may sell additional equity or debt securities or obtain credit facilities to further enhance our liquidity position, and the sale of additional equity securities could result in dilution to our stockholders.

Cash flow changes

Cash provided by operating activities is driven by our net income, adjusted for non-cash items, and non operating gains and losses from sales of investments. Non-cash adjustments include depreciation and amortization, tax benefits from stock options, earnings in equity interests, stock compensation expense. In each of the three years ended December 31, 2005, 2004, and 2003, operating cash flows were reduced by cash used for working capital needs, most significantly the increase in our accounts receivable balance, mainly reflecting increases in revenues. The days of sales outstanding metric increased slightly over the three years ended December 31, 2005. In the two years ended December 31, 2005, there were also significant increases in accrued expenses and other liabilities that provided a positive working capital change and cash flow from operations. These increases were mainly due to higher accrual balances for TAC payments to affiliates arising from increased revenue.

Cash used in investing activities is primarily attributable to capital expenditures, net cash consideration for acquisitions including our strategic investment in Alibaba and net purchases or sales of marketable debt and equity securities. Our capital expenditures totaled $409 million, $246 million and $117 million in 2005, 2004 and 2003, respectively. Our capital expenditures have been primarily for purchases of information technology assets to support our expanding offerings, our increased number of users and our international growth. Our net cash consideration for acquisitions in 2005 included approximately $1.0 billion for our investment in Alibaba, $500 million for the purchase of the outstanding interest in our joint ventures in

Europe and Korea and $54 million for the Verdisoft acquisition. The acquisitions of 3721, Kelkoo, and Musicmatch in 2004 and Inktomi and Overture in 2003 were the main uses of the net cash consideration for acquisitions in those years. Sales of equity securities generated cash in the amounts of $1,006 million, $503 million and $2 million in 2005, 2004 and 2003, respectively.

Cash provided by (used in) financing activities is driven by our financing activities relating to employee option exercises, stock repurchases and debt financing. Our cash proceeds from employee option exercises increased to approximately $747 million in 2005, compared to $651 million and $353 million in 2004 and 2003, respectively as our employee numbers and the weighted average exercise prices of our options have risen in each successive year. During 2005, we used $388 million in the direct repurchase of 11.7 million shares of our common stock at an average price of $33.20 per share. There were no comparable transactions in either 2004 or 2003. In 2005, we entered into structured stock repurchase transactions resulting in a total cash outlay of $1,395 million. These instruments settle in cash or stock depending on the market price of our common stock on the date of maturity. This $1,395 million cash outlay was offset by cash receipts of $784 million from the settlement of structured stock repurchase transactions in 2005, for a net cash usage of $611 million for these transactions in 2005. During 2004, we entered into structured stock repurchase transactions resulting in a total cash outlay of $150 million, which was offset by cash receipts of $80 million from the settlement of structured stock repurchase transactions, for a net cash usage of $70 million for these transactions in 2004. We did not have any comparable transactions in 2003.

Financing

In April 2003, we issued $750 million of zero coupon senior convertible notes (the "Notes") which are due in April 2008. These Notes are convertible into Yahoo! common stock at a conversion price of $20.50 per share, subject to adjustment upon the occurrence of certain events. Each $1,000 principal amount of the Notes will be convertible prior to April 2008 if the market price of our common stock reaches a specified threshold for a defined period of time or specified corporate transactions occur. Upon conversion, we have the right to deliver cash in lieu of common stock. As of December 31, 2005, the market price condition for convertibility of the Notes was satisfied with respect to the fiscal quarter beginning January 1, 2006 and ending March 31, 2006. We may be required to repurchase all of the Notes following a fundamental change of the Company, such as a change of control, prior to maturity at face value. We may not redeem the Notes prior to their maturity. See Note 9 — "Long-Term Debt" in the consolidated financial statements for additional information related to the long-term debt.

Stock repurchases

In March 2005, following the expiration of the $500 million stock repurchase program that was authorized in 2001 and extended in 2003, our Board of Directors authorized the repurchase of up to $3.0 billion of our outstanding shares of common stock over the next five years, depending on market conditions, share price and other factors. Repurchases may take place in the open market or in privately negotiated transactions and may be made under a Rule 10b5-1 plan. Our Board of Directors and management believe that additional repurchases made under appropriate market conditions are a prudent use of cash currently available to us in order to enhance long-term stockholder value. In 2005, under the expired and current stock repurchase programs, we repurchased 11.7 million shares of common stock at an average price of $33.20 per share for a total amount of $388 million. Subsequent to December 31, 2005, we repurchased 19 million shares of our common stock under the current stock repurchase program at an average price of $33.51 per share, for a total amount of $639 million.

Structured stock repurchases

In 2005, we entered into $1,395 million in structured stock repurchase transactions which settle in cash or stock depending on the market price of our common stock on the date of maturity of the transaction. We

enter into these structured stock repurchase transactions as part of our stock repurchase program. Of these transactions, $650 million settled in 2005 resulting in cash received of $702 million. Transactions totaling $250 million settled in January 2006 resulting in cash received of $272 million. Transactions totaling $110 million settled in February 2006 resulting in our repurchase of 3 million shares at an average price of $36.60 per share. The remaining tranches totaling $385 million will mature in the second quarter of 2006. On each of the maturity dates, if the market price of Yahoo! common stock is at or above $33.99 for the $250 million tranche and $38.66 for the $135 million tranche, we will have our investment returned with a premium. If the market price of the Yahoo! common stock is below the pre-determined prices, we will repurchase shares of our common stock, up to an aggregate of 12 million shares.

Subsequent to December 31, 2005, we entered into $250 million in structured stock repurchase transactions in tranches of $50 million and $200 million, which will mature in July 2006. On the maturity dates if the market price of Yahoo! common stock is at or above $34.50 for the $200 million tranche and $33.90 for the $50 million tranche, we will have our investment returned with a premium, otherwise we will repurchase up to an aggregate of 8 million shares.

Capital expenditures

Capital expenditures have generally comprised purchases of computer hardware, software, server equipment and furniture and fixtures. Capital expenditures, net were $409 million in 2005 and are expected to continue to increase in 2006 as we invest in the expansion of the Yahoo! Properties and its offerings. This continued increase in capital expenditures, together with the increase in operating lease commitments, is consistent with our increased headcount and operational expansion, and we anticipate that this will continue in the future as business conditions merit.

Contractual obligations and commitments

The following table presents certain payments due under contractual obligations with minimum firm commitments as of December 31, 2005 (in millions):

	Payments due by period				
	Total	Due in 2006	Due in 2007-2008	Due in 2009-2010	Thereafter
Long-term debt [1]	$ 750	$ —	$750	$ —	$ —
Operating lease obligations [2]	838	75	178	171	414
Affiliate commitments [3]	211	199	12	—	—
Non-cancelable obligations [4]	86	73	9	4	—
Total contractual obligations	$1,885	$347	$949	$175	$414

[1] The long-term debt matures in April 2008, unless converted into Yahoo! common stock at a conversion price of $20.50 per share, subject to adjustment upon the occurrence of certain events. See Note 9 — "Long-Term Debt" in the consolidated financial statements for additional information related to the long-term debt.

[2] We have entered into various non-cancelable operating lease agreements for our offices throughout the United States, and for our international subsidiaries with original lease periods up to 23 years and expiring between 2006 and 2027. See Note 13 — "Commitments and Contingencies" in the consolidated financial statements for additional information relating to our operating leases.

[3] We are obligated to make payments under contracts to provide search services to our affiliates, which represent traffic acquisition costs.

[4] We are obligated to make payments under various arrangements with vendors and other business partners, principally for marketing, bandwidth and content arrangements.

As of December 31, 2005 and 2004, we did not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities,

which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. As such, we are not exposed to the financing, liquidity, market or credit risk that could arise if we had engaged in such relationships.

Other commitments

In the ordinary course of business, we may provide indemnifications of varying scope and terms to customers, vendors, lessors, business partners and other parties with respect to certain matters, including, but not limited to, losses arising out of our breach of such agreements, services to be provided by us, or from intellectual property infringement claims made by third parties. In addition, we have entered into indemnification agreements with our directors and certain of our officers that will require us, among other things, to indemnify them against certain liabilities that may arise by reason of their status or service as directors or officers. We have also agreed to indemnify certain former officers and directors of acquired companies in connection with the acquisition of such companies. We maintain director and officer insurance, which may cover certain liabilities arising from our obligation to indemnify our directors and officers and former directors and officers of acquired companies, in certain circumstances.

It is not possible to determine the maximum potential loss under these indemnification agreements due to the limited history of prior indemnification claims and the unique facts and circumstances involved in each particular agreement. Such indemnification agreements may not be subject to maximum loss clauses. Historically, we have not incurred material costs as a result of obligations under these agreements and we have not accrued any liabilities related to such indemnification obligations in our consolidated financial statements.

On April 21, 2003, Overture completed its purchase of the Web Search unit of Fast Search and Transfer ASA, a Norway based developer of search and real-time filtering technologies, for $70 million in cash, plus a contingent earn-out payment of up to $30 million over three years based on specified operating criteria. The earn-out payment is not included in the contractual obligations table.

Critical Accounting Policies, Judgments and Estimates

Our discussion and analysis of our financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these consolidated financial statements requires us to make estimates, judgments and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses, and the related disclosure of contingent assets and liabilities. We base our estimates on historical experience and on various other assumptions that we believe are reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates.

An accounting policy is considered to be critical if it requires an accounting estimate to be made based on assumptions about matters that are highly uncertain at the time the estimates are made, and if different estimates that reasonably could have been used, or changes in the accounting estimates that are reasonably likely to occur, could materially impact the consolidated financial statements. We believe the following critical accounting policies reflect the more significant estimates and assumptions used in the preparation of the consolidated financial statements.

Revenue Recognition. Our revenues are generated from marketing services and fees. Marketing services revenue is generated from several offerings including: the display of textual, rich media advertisements, display of text based links to the advertiser's website, listing based services, and commerce based transactions. Fees revenue includes revenue from a variety of consumer and business fee-based services. While the majority of our revenue transactions contain standard business terms and conditions, there are

certain transactions that contain non-standard business terms and conditions. In addition, we may enter into certain sales transactions that involve multiple element arrangements (arrangements with more than one deliverable). We also enter into arrangements to purchase goods and/or services from certain customers. As a result, significant contract interpretation is sometimes required to determine the appropriate accounting for these transactions including: (1) whether an arrangement exists; (2) how the arrangement consideration should be allocated among potential multiple elements; (3) when to recognize revenue on the deliverables; (4) whether all elements of the arrangement have been delivered; (5) whether the arrangements should be reported gross as a principal versus net as an agent; and (6) whether we receive a separately identifiable benefit from purchase arrangements with our customers for which we can reasonably estimate fair value. In addition, our revenue recognition policy requires an assessment as to whether collection is reasonably assured, which inherently requires us to evaluate the creditworthiness of our customers. Changes in judgments on these assumptions and estimates could materially impact the timing or amount of revenue recognition.

Deferred Income Tax Asset Valuation Allowance. We record a valuation allowance to reduce our deferred income tax assets to the amount that is more likely than not to be realized. In evaluating our ability to recover our deferred income tax assets we consider all available positive and negative evidence, including our operating results, ongoing tax planning and forecasts of future taxable income on a jurisdiction by jurisdiction basis. In the event we were to determine that we would be able to realize our deferred income tax assets in the future in excess of their net recorded amount, an adjustment to the valuation allowance would likely increase stockholders' equity as substantially all of our net operating losses result from employee stock option deductions.

Goodwill and Other Intangible Assets. Goodwill is tested for impairment at the reporting unit level (operating segment or one level below an operating segment) on an annual basis and between annual tests in certain circumstances. Application of the goodwill impairment test requires judgment, including the identification of reporting units, assigning assets and liabilities to reporting units, assigning goodwill to reporting units, and determining the fair value of each reporting unit. Significant judgments required to estimate the fair value of reporting units include estimating future cash flows, determining appropriate discount rates, growth rates and other assumptions. Changes in these estimates and assumptions could materially affect the determination of fair value for each reporting unit which could trigger impairment. See Note 5 — "Goodwill" in the consolidated financial statements for additional information. Based on our 2005 impairment test, there would have to be a significant unfavorable change to our assumptions used in such calculations for an impairment to exist.

We amortize other intangible assets over their estimated useful lives. We must record an impairment charge on these assets when we determine that their carrying value may not be recoverable. The carrying value is not recoverable if it exceeds the undiscounted future cash flows resulting from the use of the asset and its eventual disposition. Based on the existence of one or more indicators of impairment, we measure any impairment of intangible assets based on a projected discounted cash flow method using a discount rate determined by our management to be commensurate with the risk inherent in our business model. Our estimates of future cash flows attributable to our other intangible assets require significant judgment based on our historical and anticipated results and are subject to many factors. Different assumptions and judgments could materially affect the calculation of the fair value of our other intangible assets which could trigger impairment.

Investments in Equity Interests. We account for investments in entities in which we can exercise significant influence but do not own a majority equity interest or otherwise control using the equity method. In accounting for these investments we record our proportionate share of these companies' net income or loss, one quarter in arrears.

We review all of our investments in equity interests for impairment whenever events or changes in business circumstances indicate that the carrying amount of the investment may not be fully recoverable. The impairment review requires significant judgment to identify events or circumstances that would likely have a significant adverse effect on the fair value of the investment. Investments identified as having an indication of impairment are subject to further analysis to determine if the impairment is other-than-temporary and this analysis requires estimating the fair value of the investment. The determination of the fair value of the investment involves considering the following factors: the stock prices of public companies in which we have an equity investment, current economic and market conditions, the operating performance of the companies including current earnings trends and undiscounted cash flows, quoted stock prices of comparable public companies, and other company specific information including recent financing rounds. The fair value determination, particularly for investments in privately-held companies, requires significant judgment to determine appropriate estimates and assumptions. Changes in these estimates and assumptions could affect the calculation of the fair value of the investments and the determination of whether any identified impairment is other-than-temporary.

Recent Accounting Pronouncements

In December 2004, the FASB issued SFAS 123R, "Share-Based Payment," which requires companies to recognize in the statement of operations all share-based payments to employees, including grants of employee stock options, based on their fair values. Accounting for share-based compensation transactions using the intrinsic method supplemented by pro forma disclosures is no longer permissible. We adopted the new requirements using the modified prospective method in the first quarter of 2006. SFAS 123R also requires excess tax benefits from the exercise of stock options to be presented in the consolidated statement of cash flows as a financing activity rather than an operating activity, as currently presented.

For purposes of pro forma disclosure of share-based compensation expense under Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees," and SFAS 123, "Accounting for Stock-Based Compensation," we have applied the accelerated amortization method outlined in FASB Interpretation No. 28, "Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans." Upon adoption of SFAS 123R, we will continue to amortize stock compensation expense related to options granted on or before December 31, 2005 using the accelerated method. For options granted after December 31, 2005, we will amortize stock compensation expense using the straight-line method.

We expect the adoption of SFAS 123R to result in stock compensation expense and therefore a reduction of income before income taxes, earnings in equity interests and minority interests in 2006 of approximately $420-$450 million. Our actual stock compensation expense amount could differ materially from this estimate depending on the timing and magnitude of new awards, the number and mix of new awards, changes in the market price or the volatility of our common stock, as well as unanticipated changes in our workforce.

In May 2005, the FASB issued SFAS No. 154, "Accounting Changes and Error Corrections," a replacement of APB Opinion No. 20, "Accounting Changes" and SFAS No. 3, "Reporting Accounting Changes in Interim Financial Statements" ("SFAS 154"). SFAS 154 changes the requirements for the accounting for and reporting of, a change in accounting principle. Previously, voluntary changes in accounting principles were generally required to be recognized by way of a cumulative effect adjustment within net income during the period of the change. SFAS 154 requires retrospective application to prior periods' financial statements, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS 154 is effective for accounting changes made in fiscal years beginning after December 15, 2005; however, the statement does not change the transition provisions of any existing accounting pronouncements. We do not believe adoption of SFAS 154 will have a material effect on our financial position, cash flows or results of operations.

Item 7A. Quantitative and Qualitative Disclosures about Market Risk

We are exposed to the impact of interest rate changes, foreign currency fluctuations, and changes in the market values of our investments.

Interest Rate Risk. Our exposure to market rate risk for changes in interest rates relates primarily to our investment portfolio. We invest excess cash in marketable debt instruments of the United States Government and its agencies, and in high-quality corporate issuers and, by policy, limit the amount of credit exposure to any one issuer. We protect and preserve invested funds by limiting default, market and reinvestment risk.

Investments in both fixed rate and floating rate interest earning instruments carry a degree of interest rate risk. Fixed rate securities may have their fair market value adversely impacted due to a rise in interest rates, while floating rate securities may produce less income than expected if interest rates fall. Due in part to these factors, our future investment income may fall short of expectations due to changes in interest rates or we may suffer losses in principal if forced to sell securities which have declined in market value due to changes in interest rates. As of December 31, 2005 and 2004, we had investments in debt securities with effective maturities between three months and one year of approximately $1.1 billion and $1.9 billion, respectively. Such investments had a weighted-average yield of approximately 3.5 percent and 2.4 percent, respectively. As of December 31, 2005 and 2004, we had investments in debt securities with effective maturities between one and five years of approximately $1.4 billion and $1.0 billion, respectively. Such investments had a weighted average yield of approximately 3.8 percent and 3.0 percent, respectively. A hypothetical 100 basis point increase in interest rates would result in an approximate $26 million and $25 million decrease (approximately 1 percent), respectively, in the fair value of our available-for-sale debt securities as of December 31, 2005 and 2004.

The fair market value of the zero coupon senior convertible notes (the "Notes") is subject to interest rate risk and market risk due to the convertible feature of the Notes. Generally, the fair market value of fixed interest rate debt will increase as interest rates fall and decrease as interest rates rise. The fair market value of the Notes will also increase as the market price of the Yahoo! stock increases and decrease as the market price falls. The interest and market value changes affect the fair market value of the Notes but do not impact our financial position, cash flows or results of operations. As of December 31, 2005 and 2004, the fair value of the Notes was approximately $1.4 billion based on quoted market prices.

Foreign Currency Risk. International revenues accounted for approximately 30 percent of total revenues during 2005 as compared to 26 percent during 2004. The growth in our international operations has increased our exposure to foreign currency fluctuations. Revenues and related expenses generated from our international subsidiaries are generally denominated in the functional currencies of the local countries. Primary currencies include Euros, British Pounds, Japanese Yen, Korean Won and Australian Dollars. The statements of operations of our international operations are translated into United States dollars at the average exchange rates in each applicable period. To the extent the United States dollar strengthens against foreign currencies, the translation of these foreign currency denominated transactions results in reduced revenues, operating expenses and net income for our International segment. Similarly, our revenues, operating expenses and net income will increase for our International segment, if the United States dollar weakens against foreign currencies. Using the average foreign currency exchange rates from 2004, our international revenues for 2005 would have been lower than we reported by approximately $42 million and our international segment operating income before depreciation and amortization would have been lower than we reported by $8 million. Using the average foreign currency exchange rates from 2003, our international revenues for 2004 would have been lower than we reported by approximately $59 million and our international segment operating income before depreciation and amortization would have been lower than we reported by $10 million.

We are also exposed to foreign exchange rate fluctuations as we convert the financial statements of our foreign subsidiaries into United States dollars in consolidation. If there is a change in foreign currency exchange rates, the conversion of the foreign subsidiaries' financial statements into United States dollars will lead to a translation gain or loss which is recorded as a component of other comprehensive income. In addition, we have certain assets and liabilities that are denominated in currencies other than the relevant entity's functional currency. Changes in the functional currency value of these assets and liabilities create fluctuations that will lead to a transaction gain or loss. During 2005, we recorded foreign currency transaction losses, realized and unrealized, of approximately $8 million as compared to gains of $6 million and $3 million in 2004 and 2003, respectively, which were recorded in other income, net on the consolidated statement of operations.

Investment Risk. The primary objective of our investment activities is to preserve principal while at the same time maximizing yields without significantly increasing risk. To achieve this objective, we maintain our portfolio of cash equivalents and current and long-term investments in a variety of securities, including both government and corporate obligations and money market funds. As of December 31, 2005 and 2004, net unrealized losses on these investments were not material.

We are exposed to market risk as it relates to changes in the market value of our investments. We invest in equity instruments of public companies for business and strategic purposes and have classified these securities as available-for-sale. These available-for-sale equity investments are subject to significant fluctuations in fair value due to the volatility of the stock market and the industries in which these companies participate. We have realized gains and losses from the sale of investments, as well as impairment charges on some of our investments. In 2005, we recorded an impairment loss of $28 million on an available-for-sale equity investment. Our investments in available-for-sale equity securities were not material as of December 31, 2005. As of December 31, 2004, we had available-for-sale equity investments with a fair value of approximately $812 million, classified as current assets and included on the consolidated balance sheets as marketable equity securities. These equity investments were sold in 2005. Our objective in managing exposure to stock market fluctuations is to minimize the impact of stock market declines to earnings and cash flows. Using a hypothetical reduction of 10 percent in the stock price of these equity securities, the fair value of our equity investments would decrease by approximately $3 million and $80 million as of December 31, 2005 and 2004, respectively.

Item 8. Financial Statements and Supplementary Data

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Report of Independent Registered Public Accounting Firm

To the Board of Directors and Stockholders of Yahoo! Inc.:

We have completed integrated audits of Yahoo! Inc.'s 2005 and 2004 consolidated financial statements and of its internal control over financial reporting as of December 31, 2005 and an audit of its 2003 consolidated financial statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Our opinions, based on our audits, are presented below.

Consolidated financial statements and financial statement schedule

In our opinion, the consolidated financial statements listed in the accompanying index present fairly, in all material respects, the financial position of Yahoo! Inc. and its subsidiaries as of December 31, 2005 and 2004, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2005 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule listed in the accompanying index presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit of financial statements includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

Internal control over financial reporting

Also, in our opinion, management's assessment, included in Management's Report on Internal Control over Financial Reporting appearing under Item 9A, that the Company maintained effective internal control over financial reporting as of December 31, 2005 based on criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), is fairly stated, in all material respects, based on those criteria. Furthermore, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2005, based on criteria established in *Internal Control — Integrated Framework* issued by the COSO. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express opinions on management's assessment and on the effectiveness of the Company's internal control over financial reporting based on our audit. We conducted our audit of internal control over financial reporting in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. An audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we consider necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed 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. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ PricewaterhouseCoopers LLP

San Jose, California
March 3, 2006

Consolidated Statements of Operations YAHOO! INC.

(in thousands, except per share amounts)

	Years Ended December 31,		
	2003	2004	2005
Revenues	$1,625,097	$3,574,517	$5,257,668
Cost of revenues	370,092	1,342,338	2,096,201
Gross profit	1,255,005	2,232,179	3,161,467
Operating expenses:			
Sales and marketing	530,613	778,029	1,025,249
Product development	207,285	368,760	547,137
General and administrative	157,027	262,602	319,690
Stock compensation expense [1]	22,029	32,290	52,471
Amortization of intangibles	42,385	101,917	109,195
Total operating expenses	959,339	1,543,598	2,053,742
Income from operations	295,666	688,581	1,107,725
Other income, net	47,506	496,443	1,435,857
Income before income taxes, earnings in equity interests and minority interests	343,172	1,185,024	2,543,582
Provision for income taxes	(147,024)	(437,966)	(767,816)
Earnings in equity interests	47,652	94,991	128,244
Minority interests in operations of consolidated subsidiaries	(5,921)	(2,496)	(7,780)
Net income	$ 237,879	$ 839,553	$1,896,230
Net income per share — basic	$ 0.19	$ 0.62	$ 1.35
Net income per share — diluted	$ 0.18	$ 0.58	$ 1.28
Shares used in per share calculation — basic	1,233,480	1,353,439	1,400,421
Shares used in per share calculation — diluted	1,310,796	1,452,499	1,485,591
[1] Stock compensation expense by function:			
Sales and marketing	$ 5,785	$ 9,620	$ 8,698
Product development	10,526	12,010	22,390
General and administrative	5,718	10,660	21,383
Total stock compensation expense	$ 22,029	$ 32,290	$ 52,471

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

Consolidated Balance Sheets YAHOO! INC.

(in thousands, except par values)

	December 31, 2004	December 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 823,723	$ 1,429,693
Marketable debt securities	1,875,964	1,131,141
Marketable equity securities	812,288	—
Accounts receivable, net of allowance of $34,215 and $41,857, respectively	479,993	721,723
Prepaid expenses and other current assets	98,507	166,976
Total current assets	4,090,475	3,449,533
Long-term marketable debt securities	1,042,575	1,439,014
Property and equipment, net	531,696	697,522
Goodwill	2,550,957	2,895,557
Intangible assets, net	480,666	534,615
Other assets	242,029	57,192
Investments in equity interests	239,803	1,758,401
Total assets	$9,178,201	$10,831,834
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 48,205	$ 70,291
Accrued expenses and other current liabilities	853,115	827,589
Deferred revenue	279,387	306,172
Total current liabilities	1,180,707	1,204,052
Long-term deferred revenue	65,875	67,792
Long-term debt	750,000	749,995
Other long-term liabilities	35,907	243,580
Commitments and contingencies (Note 13)		
Minority interests in consolidated subsidiaries	44,266	—
Stockholders' equity:		
Preferred stock, $0.001 par value; 10,000 shares authorized; none issued or outstanding	—	—
Common stock, $0.001 par value; 5,000,000 shares authorized; 1,383,584 and 1,430,162 issued and outstanding, respectively	1,416	1,470
Additional paid-in capital	5,682,884	6,417,858
Deferred stock-based compensation	(28,541)	(235,394)
Treasury stock	(159,988)	(547,723)
Retained earnings	1,069,939	2,966,169
Accumulated other comprehensive income (loss)	535,736	(35,965)
Total stockholders' equity	7,101,446	8,566,415
Total liabilities and stockholders' equity	$9,178,201	$10,831,834

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

Consolidated Statements of Cash Flows YAHOO! INC.

(in thousands)

	Years Ended December 31,		
	2003	2004	2005
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income	$ 237,879	$ 839,553	$ 1,896,230
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	159,688	311,041	397,142
Tax benefits from stock options	124,852	408,976	759,530
Earnings in equity interests	(47,652)	(94,991)	(128,244)
Dividends received	—	—	10,670
Minority interests in operations of consolidated subsidiaries	5,921	2,496	7,780
Stock compensation expense	22,029	32,290	52,471
(Gains)/losses from sales of investments, assets and other, net	11,047	(394,028)	(1,278,311)
Changes in assets and liabilities, net of effects of acquisitions:			
Accounts receivable, net	(122,220)	(162,690)	(272,387)
Prepaid expenses and other	16,835	(12,217)	(35,344)
Accounts payable	(12,889)	(3,570)	31,574
Accrued expenses and other liabilities	(640)	113,953	212,112
Deferred revenue	33,294	49,008	58,160
Net cash provided by operating activities	428,144	1,089,821	1,711,383
CASH FLOWS FROM INVESTING ACTIVITIES:			
Acquisition of property and equipment, net	(117,329)	(245,501)	(408,934)
Purchases of marketable debt securities	(4,686,286)	(3,449,155)	(7,023,802)
Proceeds from sales and maturities of marketable debt securities	3,837,940	2,642,621	7,341,974
Acquisitions, net of cash acquired	(377,986)	(761,605)	(1,698,164)
Proceeds from sales of marketable equity securities	1,928	502,806	1,006,142
Other investing activities, net	(604)	17,985	(39,146)
Net cash used in investing activities	(1,342,337)	(1,292,849)	(821,930)
CASH FLOWS FROM FINANCING ACTIVITIES:			
Proceeds from issuance of debt, net	733,125	—	—
Proceeds from issuance of common stock, net	353,201	650,525	746,807
Repurchases of common stock	—	—	(387,735)
Structured stock repurchases, net	—	(69,558)	(611,421)
Other financing activities, net		—	1,749
Net cash provided by (used in) financing activities	1,086,326	580,967	(250,600)
Effect of exchange rate changes on cash and cash equivalents	9,686	29,892	(32,883)
Net change in cash and cash equivalents	181,819	407,831	605,970
Cash and cash equivalents at beginning of year	234,073	415,892	823,723
Cash and cash equivalents at end of year	$ 415,892	$ 823,723	$ 1,429,693

Consolidated Statements of Cash Flows YAHOO! INC. (Continued)

(in thousands, unless otherwise stated)

Supplemental cash flow disclosures:

Income taxes paid were $11 million, $22 million, and $51 million in the years ended December 31, 2003, 2004, and 2005, respectively. Interest paid was not material in any year presented.

Acquisition-related activities:

	Years Ended December 31,		
	2003	2004	2005
Cash paid for acquisitions	$ 583,269	$821,034	$1,700,898
Cash acquired in acquisitions	(205,283)	(59,429)	(2,734)
	$ 377,986	$761,605	$1,698,164
Fair value of common stock, restricted stock and common stock options issued in connection with acquisitions	$1,428,259	$ 4,313	$ 44,773

During the year ended December 31, 2005 the Company issued approximately 1 million shares of restricted stock and during the year ended December 31, 2003, the Company issued approximately 79 million shares of common stock, in connection with acquisitions. No shares of common or restricted stock were issued during the year ended December 31, 2004 in connection with acquisitions. See Note 3 — "Acquisitions" for additional information.

During the year ended December 31, 2005, the Company contributed its China based businesses ("Yahoo China") as partial consideration for its investment in Alibaba.com Corporation ("Alibaba"). See Note 4 — "Investments in Equity Interests" for additional information.

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

Consolidated Statements of Stockholders' Equity YAHOO! INC.

(in thousands)

	Years Ended December 31,		
	2003	2004	2005
Common stock			
Balance, beginning of year	$ 1,222	$ 1,354	$ 1,416
Common stock issued	132	62	54
Balance, end of year	1,354	1,416	1,470
Additional paid-in capital			
Balance, beginning of year	2,431,903	4,340,514	5,682,884
Common stock and restricted stock awards issued and stock options assumed	1,791,760	667,212	1,010,012
Tax benefits from stock options	116,851	744,716	336,383
Structured stock repurchases, net	—	(69,558)	(611,421)
Balance, end of year	4,340,514	5,682,884	6,417,858
Deferred stock-based compensation			
Balance, beginning of year	(2,292)	(52,374)	(28,541)
Common stock and restricted stock awards issued and stock options assumed	(72,111)	(8,457)	(259,324)
Stock compensation expense	22,029	32,290	52,471
Balance, end of year	(52,374)	(28,541)	(235,394)
Treasury stock			
Balance, beginning of year	(159,988)	(159,988)	(159,988)
Repurchases of common stock	—	—	(387,735)
Balance, end of year	(159,988)	(159,988)	(547,723)
Retained earnings (accumulated deficit)			
Balance, beginning of year	(7,493)	230,386	1,069,939
Net income	237,879	839,553	1,896,230
Balance, end of year	230,386	1,069,939	2,966,169
Accumulated other comprehensive income (loss)			
Balance, beginning of year	(1,082)	3,598	535,736
Net change in unrealized gains/losses on available-for-sale securities, net of tax	(6,705)	471,425	(491,532)
Foreign currency translation adjustment	11,385	60,713	(80,169)
Balance, end of year	3,598	535,736	(35,965)
Total stockholders' equity	$4,363,490	$7,101,446	$8,566,415
Comprehensive income			
Net income	$ 237,879	$ 839,553	$1,896,230
Other comprehensive income (loss):			
Unrealized gains/losses on available-for-sale securities, net of taxes of $1,642, $(315,001), and $7,669 for 2003, 2004, and 2005, respectively	(2,498)	472,532	(11,510)
Reclassification adjustment for realized gains included in net income, net of taxes of $2,804, $738, and $320,015 for 2003, 2004, and 2005, respectively	(4,207)	(1,107)	(480,022)
Net change in unrealized gains (losses) on available-for-sale securities, net of tax	(6,705)	471,425	(491,532)
Foreign currency translation adjustment	11,385	60,713	(80,169)
Other comprehensive income (loss)	4,680	532,138	(571,701)
Comprehensive income	$ 242,559	$1,371,691	$1,324,529
	Number of Shares		
Common stock			
Balance, beginning of year	1,189,720	1,321,408	1,383,584
Common stock and restricted stock issued	131,688	62,176	58,258
Repurchases of common stock	—	—	(11,680)
Balance, end of year	1,321,408	1,383,584	1,430,162

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

Notes to Consolidated Financial Statements YAHOO! INC.

Note 1 THE COMPANY AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The Company. Yahoo! Inc., together with its consolidated subsidiaries ("Yahoo!" or the "Company"), is a leading global Internet brand and one of the most trafficked Internet destinations worldwide. Yahoo! seeks to provide Internet services that are essential and relevant to users and businesses. To users, Yahoo! provides its owned and operated online properties and services (the "Yahoo! Properties"). To businesses, Yahoo! provides a range of tools and marketing solutions designed to enable businesses to reach the Yahoo! community of users.

Stock Split. On April 7, 2004, the Yahoo! Board of Directors approved a two-for-one split of the Company's shares of common stock effected in the form of a stock dividend. As a result of the stock split, Yahoo! stockholders received one additional share of Yahoo! common stock for each share of common stock held of record on April 26, 2004. The additional shares of Yahoo! common stock were distributed on May 11, 2004. All share and per share amounts in these consolidated financial statements and related notes have been retroactively adjusted to reflect the stock split for all periods presented.

Basis of Presentation. The consolidated financial statements include the accounts of Yahoo! and its majority-owned or otherwise controlled subsidiaries. All significant intercompany accounts and transactions have been eliminated. Investments in entities in which the Company can exercise significant influence, but does not own a majority equity interest or otherwise control, are accounted for using the equity method and are included as Investments in equity interests on the consolidated balance sheets. The Company has included the results of operations of acquired companies from the date of acquisition.

Certain prior year amounts have been reclassified to conform to the current year presentation. The Company has changed the classification of amortization expense related to developed technology and patents in the consolidated statements of operations. This amortization expense of $12 million, $44 million, and $64 million for 2003, 2004, and 2005, respectively, was previously included as part of operating expenses and has been reclassified to cost of revenues for all periods presented.

The preparation of consolidated financial statements in conformity with generally accepted accounting principles in the United States requires management to make estimates, judgments and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses and the related disclosure of contingent assets and liabilities. On an on-going basis, the Company evaluates its estimates, including those related to uncollectible receivables, the useful lives of long-lived assets including property and equipment, investment fair values, goodwill and other intangible assets, income taxes and contingencies. In addition, the Company uses assumptions when employing the Black-Scholes option valuation model to estimate the fair value of stock options granted for pro forma disclosure purposes. The Company bases its estimates of the carrying value of certain assets and liabilities on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, when these carrying values are not readily available from other sources. Actual results may differ from these estimates.

Revenue Recognition. The Company's revenues are derived principally from services, which comprise marketing services for businesses and offerings to users. The Company classifies these revenues as marketing services and fees.

The Company recognizes revenue on arrangements in accordance with Securities and Exchange Commission Staff Accounting Bulletin No. 104 "Revenue Recognition," ("SAB 104") and Financial Accounting Standard Board's Emerging Issues Task Force ("EITF") Issue No. 00-21, "Revenue Arrangements with Multiple Deliverables." In all cases, revenue is recognized only when the price is fixed or determinable, persuasive evidence of an arrangement exists, the service is performed and collectibility of the resulting receivable is reasonably assured. In accordance with EITF No. 01-9, "Accounting for Consideration Given by a Vendor to a Customer or a Reseller of the Vendor's Product," the Company

accounts for cash consideration given to customers, for which it does not receive a separately identifiable benefit or cannot reasonably estimate fair value, as a reduction of revenue rather than as an expense.

Marketing services revenue is generated from several offerings including: the display of rich media advertisements, display of text based links to the advertiser's website, listing based services and commerce based transactions.

The Company recognizes revenue related to the display of advertisements on the Yahoo! Properties as "impressions" are delivered. An "impression" is delivered when an advertisement appears in pages viewed by users. Arrangements for these services generally have terms of up to three years and in the majority of cases, the terms are less than one year or may be terminated at any time by the advertiser. Some of these advertising agreements may involve multiple element arrangements (arrangements with more than one deliverable).

The Company generates revenue from the display of text based links to the websites of its advertisers which are placed on the Yahoo! Properties as well as on the websites of third party entities (which the Company refers to as "affiliates") who have integrated the Company's search offerings into their websites. The Company recognizes revenue from these arrangements as "click-throughs" occur. A "click-through" occurs when a user clicks on an advertiser's listing. The Company pays affiliates based on click-throughs on the advertiser's listings that are displayed on the websites of these affiliates. These payments are called traffic acquisition costs. In accordance with EITF Issue No. 99-19, "Reporting Revenue Gross as a Principal Versus Net as an Agent," the revenue derived from these arrangements that involve traffic supplied by affiliates is reported gross of the payment to affiliates. This revenue is reported gross due to the fact that the Company is the primary obligor to the advertisers who are the customers of the advertising service.

Listings revenue is generated from a variety of consumer and business listings-based services, including access to Yahoo! HotJobs database and classifieds such as Yahoo! Autos, Yahoo! Real Estate and other services. The Company recognizes listings revenue when the services are performed.

Transaction revenue is generated from facilitating commerce based transactions through the Yahoo! Properties, principally from Yahoo!'s commerce properties including Yahoo! Travel and Yahoo! Shopping. The Company recognizes transaction revenue when there is evidence that qualifying transactions have occurred, for example, when travel arrangements are booked through Yahoo! Travel.

Fees revenue consists of revenues generated from a variety of consumer and business fee-based services, including Internet broadband services, premium mail, music and personals offerings as well as services for small businesses. The Company recognizes fees revenue when the services are performed.

Current deferred revenue primarily comprises contractual billings in excess of recognized revenue and payments received in advance of revenue recognition. Long-term deferred revenue includes amounts received from customers for which services will not be delivered within the next 12 months. Long-term deferred revenue also includes amounts that arose on the settlement of a litigation dispute. See Note 14 — "Litigation Settlement" for additional information.

Allowance for Doubtful Accounts. The Company records its allowance for doubtful accounts based upon its assessment of various factors. The Company considers historical experience, the age of the accounts receivable balances, the credit quality of its customers, current economic conditions and other factors that may affect customers' ability to pay to determine the level of allowance required.

Traffic Acquisition Costs. Traffic acquisition costs consist of payments made to affiliates that have integrated the Company's search offerings into their websites and payments made to companies that direct consumer and business traffic to the Yahoo! Properties. The Company enters into agreements of varying duration that involve these traffic acquisition costs. There are generally three economic structures of the affiliate agreements: fixed payments based on a guaranteed minimum amount of traffic delivered, which

often carry reciprocal performance guarantees from the affiliate; variable payments based on a percentage of the Company's revenue or based on a certain metric, such as number of searches or paid clicks; or a combination of the two. The Company expenses, as cost of revenues, traffic acquisition costs associated with affiliate arrangements under two different methods depending on the structure of the agreement. Agreements with fixed payments are expensed ratably over the term the fixed payment covers. Agreements based on a percentage of revenue, number of paid introductions, number of searches, or other metrics are expensed based on the volume of the underlying activity or revenue multiplied by the agreed-upon price or rate.

Internal Use Software and Website Development Costs. The Company has capitalized certain internal use software and website development costs totaling approximately $11 million, $19 million, and $18 million during 2003, 2004, and 2005, respectively. The estimated useful life of costs capitalized is evaluated for each specific project and ranges from one to three years. During 2003, 2004, and 2005, the amortization of capitalized costs totaled approximately $9 million, $11 million, and $18 million, respectively. Capitalized internal use software and website development costs are included in property and equipment, net.

Product Development. Product development expenses consist primarily of compensation related expenses incurred for enhancements to and maintenance of the Yahoo! Properties, classification and organization of listings within Yahoo! Properties, and research and development as well as depreciation expense and other operating costs.

Advertising Costs. Advertising production costs are recorded as expense the first time an advertisement appears. Costs of communicating advertising are recorded as expense as advertising space or airtime is used. All other advertising costs are expensed as incurred. Advertising expense totaled approximately $115 million, $160 million, and $201 million for 2003, 2004, and 2005, respectively.

Stock-Based Compensation. The Company measures compensation expense for its stock-based employee compensation plans using the intrinsic value method. This expense is generally being amortized using the accelerated amortization method in accordance with Financial Accounting Standards Board ("FASB") Interpretation No. 28 "Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans." If the fair value based method had been applied in measuring stock compensation expense, the pro forma effect on net income and net income per share would have been as follows (in thousands, except per share amounts):

	Years Ended December 31,		
	2003	2004	2005
Net income:			
As reported	$ 237,879	$ 839,553	$1,896,230
Add: Stock compensation expense included in reported net income, net of related tax effects	12,987	19,374	31,557
Less: Stock compensation expense determined under fair value based method for all awards, net of related tax effects	(183,515)	(235,728)	(239,408)
Pro forma net income	$ 67,351	$ 623,199	$1,688,379
Net income per share:			
As reported — basic	$ 0.19	$ 0.62	$ 1.35
As reported — diluted	$ 0.18	$ 0.58	$ 1.28
Pro forma — basic	$ 0.05	$ 0.46	$ 1.21
Pro forma — diluted	$ 0.05	$ 0.43	$ 1.13

The recorded stock compensation expense relates to the amortization of the intrinsic value of Yahoo! stock options issued and assumed in connection with business combinations and other equity-based awards issued by the Company.

See Note 12 — "Employee Benefits" for the assumptions and methodology used to determine the fair value of stock-based compensation.

See "Recent Accounting Pronouncements" below regarding the impact of the adoption of Statement of Financial Accounting Standards ("SFAS") No. 123R ("SFAS 123R"), "Share-Based Payment."

Income Taxes. Deferred income taxes are determined based on the differences between the financial reporting and tax bases of assets and liabilities and are measured using the currently enacted tax rates and laws. The provision for income taxes comprises the Company's current tax liability and change in deferred income tax assets and liabilities. A valuation allowance is provided to reduce deferred income tax assets to the amount that, based on available evidence, is more likely than not to be realized.

Comprehensive Income. Comprehensive income consists of two components, net income and other comprehensive income (loss). Other comprehensive income (loss) refers to gains and losses that under generally accepted accounting principles are recorded as an element of stockholders' equity but are excluded from net income. The Company's other comprehensive income (loss) is comprised of foreign currency translation adjustments and unrealized gains and losses on marketable securities categorized as available-for-sale.

Cash and Cash Equivalents, Short and Long-Term Investments. The Company invests its excess cash in debt instruments of the United States Government and its agencies and in high-quality corporate issuers which are classified as marketable debt securities. All highly liquid investments with an original maturity of three months or less are considered cash equivalents. Investments with effective maturities of less than 12 months from the balance sheet date are classified as current assets. Investments with effective maturities greater than 12 months from the balance sheet date are classified as long-term assets.

The Company's marketable debt and equity securities are classified as available-for-sale and are reported at fair value, with unrealized gains and losses, net of tax, recorded in accumulated other comprehensive income (loss). Realized gains or losses and declines in value judged to be other than temporary, if any, on available-for-sale securities are reported in other income, net. The Company evaluates the investments periodically for possible other-than-temporary impairment and reviews factors such as the length of time and extent to which fair value has been below cost basis, the financial condition of the issuer and the Company's ability and intent to hold the investment for a period of time which may be sufficient for anticipated recovery in market value. The Company records impairment charges equal to the amount that the carrying value of its available-for-sale securities exceeds the estimated fair market value of the securities as of the evaluation date, if appropriate. The fair value for securities is determined based on quoted market prices as of the valuation date. In computing realized gains and losses on available-for-sale securities, the Company determines cost based on amounts paid, including direct costs such as commissions, to acquire the security using the specific identification method. During the year ended December 31, 2005, realized gains and losses on available-for-sale debt securities were not material.

Investments in Equity Interests. Investments in entities in which the Company can exercise significant influence but does not own a majority equity interest or otherwise control, are accounted for using the equity method and included as Investments in equity interests on the consolidated balance sheets. The Company records its share of the results of these companies one quarter in arrears within earnings in equity interests on the consolidated statements of operations. The Company monitors its investments for other-than-temporary impairment by considering factors including the stock price of public companies in which it has an equity investment as well as current economic and market conditions and the operating performance of the companies and records reductions in carrying values when necessary. The fair value of privately held investments is estimated using the best available information as of the valuation date, including current earnings trends, undiscounted cash flows, quoted stock prices of comparable public companies, and other company specific information, including recent financing rounds.

The carrying amounts of these investments are greater than the underlying equity in net assets of these companies due in part to goodwill, which is not subject to amortization in accordance with SFAS No. 142 ("SFAS 142") "Goodwill and Other Intangible Assets." This goodwill is evaluated for impairment in accordance with Accounting Principles Board ("APB") Opinion No. 18, "The Equity Method of Accounting for Investments in Common Stock."

Concentration of Risk. Financial instruments that potentially subject the Company to significant concentration of credit risk consist primarily of cash, cash equivalents, marketable debt securities and accounts receivable. As of December 31, 2005, substantially all of the Company's cash, cash equivalents and investments were managed by six financial institutions. Accounts receivable are typically unsecured and are derived from revenue earned from customers. The Company performs ongoing credit evaluations of its customers and maintains allowances for potential credit losses. Historically, such losses have been within management's expectations. As of December 31, 2004 and 2005, no one customer accounted for 10 percent or more of the accounts receivable balance and no one customer accounted for 10 percent or more of the Company's revenues for 2003, 2004, or 2005.

Long-Lived Assets.

Property and Equipment. Buildings are stated at cost and depreciated using the straight-line method over the estimated useful lives of 25 years. Leasehold improvements are amortized over the lesser of their expected useful life and the remaining lease term. Computers and equipment and furniture and fixtures are stated at cost and depreciated using the straight-line method over the estimated useful lives of the assets, generally two to five years. The Company recognized depreciation expense on property and equipment of approximately $105 million, $165 million and $224 million for 2003, 2004, and 2005, respectively.

Goodwill. Goodwill is carried at cost. Goodwill is not amortized but is subject to an annual test for impairment at the reporting unit level (operating segment or one level below an operating segment) and between annual tests in certain circumstances. The performance of the test involves a two-step process. The first step of the impairment test involves comparing the fair value of the Company's reporting units with the reporting unit's carrying amount, including goodwill. The Company generally determines the fair value of its reporting units using the expected present value of future cash flows, giving consideration to the market valuation approach. If the carrying amount of a reporting unit exceeds the reporting unit's fair value, the Company performs the second step of the goodwill impairment test to determine the amount of impairment loss. The second step of the goodwill impairment test involves comparing the implied fair value of the reporting unit's goodwill with the carrying amount of that goodwill.

Intangible Assets Other than Goodwill. Intangible assets other than goodwill are carried at cost less accumulated amortization. Intangible assets are generally amortized on a straight-line basis over the useful lives of the respective assets, generally two to seven years. Long-lived assets and certain identifiable intangible assets to be held and used are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. Determination of recoverability is based on an estimate of undiscounted future cash flows resulting from the use of the asset and its eventual disposition. Measurement of any impairment loss for long-lived assets and certain identifiable intangible assets that management expects to hold and use is based on the amount the carrying value exceeds the fair value of the asset.

Foreign Currency. The functional currency of the Company's international subsidiaries is generally the local currency. The financial statements of these subsidiaries are translated into United States dollars using period-end rates of exchange for assets and liabilities and average rates of exchange for the period for revenues and expenses. Translation gains (losses) are recorded in accumulated other comprehensive income (loss) as a component of stockholders' equity. The Company recorded net foreign currency transaction gains, realized and unrealized, of approximately $3 million and $6 million in 2003 and 2004,

respectively, and net foreign currency transaction losses, realized and unrealized, of $8 million in 2005, which were included in other income, net.

Operating Leases. The Company leases office space and data centers under operating lease agreements with original lease periods up to 23 years. Certain of the lease agreements contain rent holidays and rent escalation provisions. Rent holidays and rent escalation provisions are considered in determining straight-line rent expense to be recorded over the lease term. The lease term begins on the date of initial possession of the lease property for purposes of recognizing lease expense on a straight-line basis over the term of the lease. Lease renewal periods are considered on a lease-by-lease basis and are generally not included in the initial lease term.

Recent Accounting Pronouncements

In December 2004, the FASB issued SFAS No. 123R, "Share-Based Payment," which requires companies to recognize in the statement of operations all share-based payments to employees, including grants of employee stock options, based on their fair values. Accounting for share-based compensation transactions using the intrinsic method supplemented by pro forma disclosures is no longer permissible. The Company adopted the new requirements using the modified prospective method in the first quarter of 2006. SFAS 123R also requires excess tax benefits from the exercise of stock options to be presented in the consolidated statements of cash flows as a financing activity rather than an operating activity, as currently presented.

For purposes of pro forma disclosure of share-based compensation expense under APB Opinion No. 25, "Accounting for Stock Issued to Employees," and SFAS 123, "Accounting for Stock-Based Compensation," the Company has applied the accelerated amortization method outlined in FASB Interpretation No. 28, "Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans." Upon adoption of SFAS 123R, the Company will continue to amortize stock compensation expense related to options granted on or before December 31, 2005 using the accelerated method. For options and other equity-based awards granted after December 31, 2005, the Company will amortize stock compensation expense using the straight-line method.

The Company expects the adoption of SFAS 123R to result in stock compensation expense and therefore a reduction of income before income taxes, earnings in equity interests and minority interests in 2006 of approximately $420-$450 million. The Company's actual stock compensation expense in 2006 could differ materially from this estimate depending on the timing and magnitude of new awards, the number and mix of new awards, changes in the market price or the volatility of the Company's common stock, as well as unanticipated changes in the Company's workforce.

In May 2005, the FASB issued SFAS No. 154, "Accounting Changes and Error Corrections," a replacement of APB Opinion No. 20, "Accounting Changes" and SFAS No. 3, "Reporting Accounting Changes in Interim Financial Statements" ("SFAS 154"). SFAS 154 changes the requirements for the accounting for, and reporting of, a change in accounting principle. Previously, voluntary changes in accounting principles were generally required to be recognized by way of a cumulative effect adjustment within net income during the period of the change. SFAS 154 requires retrospective application to prior periods' financial statements, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS 154 is effective for accounting changes made in fiscal years beginning after December 15, 2005; however, the statement does not change the transition provisions of any existing accounting pronouncements. The Company does not believe adoption of SFAS 154 will have a material effect on its financial position, cash flows or results of operations.

Note 2 Basic and Diluted Net Income Per Share

Basic net income per share is computed using the weighted average number of common shares outstanding during the period, excluding any unvested restricted stock that is subject to repurchase. Diluted net income per share is computed using the weighted average number of common shares and, if dilutive, potential common shares outstanding during the period. Potential common shares consist of unvested restricted stock awards (using the treasury stock method), the incremental common shares issuable upon the exercise of stock options (using the treasury stock method) and the conversion of the Company's zero coupon senior convertible notes (using the if-converted method). For 2003, 2004, and 2005, approximately 87 million, 50 million and 55 million options to purchase common stock, respectively, were excluded from the calculation, as the exercise prices were greater than the average market price of the common stock during the respective years. See Note 9 — "Long-Term Debt" for additional information.

The following table sets forth the computation of basic and diluted net income per share (in thousands, except per share amounts):

	Years Ended December 31,		
	2003	2004	2005
Numerator:			
Net income	$ 237,879	$ 839,553	$1,896,230
Denominator:			
Weighted average common shares	1,233,480	1,353,942	1,403,963
Weighted average unvested restricted stock subject to repurchase	—	(503)	(3,542)
Denominator for basic calculation	1,233,480	1,353,439	1,400,421
Weighted average effect of dilutive securities:			
Employee stock options	50,681	62,228	48,552
Convertible notes	26,635	36,585	36,585
Restricted stock	—	247	33
Denominator for diluted calculation	1,310,796	1,452,499	1,485,591
Net income per share — basic	$ 0.19	$ 0.62	$ 1.35
Net income per share — diluted	$ 0.18	$ 0.58	$ 1.28

Note 3 ACQUISITIONS

The following table summarizes significant acquisitions (including business combinations, asset acquisitions and a strategic investment) completed during the three years ended December 31, 2005 (in millions):

	Purchase Price	Goodwill	Amortizable Intangibles
2003			
Inktomi	$ 290	$ 208	$ 49
Overture	$1,732	$1,147	$354
2004			
3721	$ 95	$ 81	$ 12
Kelkoo	$ 571	$ 454	$107
Musicmatch	$ 158	$ 172	$ 21
Other acquisitions	$ 49	$ 41	$ 14
2005			
Verdisoft	$ 58	—	$ 93
Yahoo! Europe [1] and Yahoo! Korea	$ 501	$ 388	$ 87
Other acquisitions	$ 79	$ 58	$ 32
Alibaba (see Note 4 — "Investments in Equity Interests")			

[1] Yahoo! Europe refers to three separate companies, Yahoo! France, Yahoo! Germany and Yahoo! UK, collectively called "Yahoo! Europe", previously joint ventures with SOFTBANK Corp. ("SOFTBANK").

Acquisitions completed in 2003

Inktomi. On March 19, 2003, the Company completed the acquisition of Inktomi Corporation ("Inktomi"), a provider of search and paid inclusion services on the Internet. The acquisition combined the Company's global audience and Inktomi's search technology to allow the Company to create a more relevant, comprehensive and higher quality search offering on the Internet. In February 2004, the Company launched its own branded algorithmic search technology, Yahoo! Search Technology, based on Inktomi's search technology and began deployment on a worldwide basis. These factors contributed to a purchase price in excess of the fair value of the net tangible and intangible assets acquired from Inktomi and as a result, the Company has recorded goodwill in connection with this transaction.

The total purchase price of approximately $290 million consisted of $273 million in cash consideration, $14 million related to 2 million stock options exchanged and direct transaction costs of $3 million. The $273 million of total cash consideration less cash acquired of approximately $45 million resulted in a net cash outlay of $228 million. The value of the stock options was determined using the Black-Scholes option valuation model.

The allocation of the purchase price to the assets acquired and liabilities assumed based on the fair values was as follows (in thousands):

Cash acquired	$ 44,610
Other tangible assets acquired	37,143
Amortizable intangible assets:	
Customer and advertiser related relationships	23,500
Developed technology and patents	25,900
Goodwill	207,804
Total assets acquired	338,957
Liabilities assumed	(50,638)
Deferred stock-based compensation	1,287
Total	$289,606

The amortizable intangible assets have useful lives of five years. No amount has been allocated to in-process research and development and $208 million has been allocated to goodwill. Goodwill represents the excess of the purchase price over the fair value of the net tangible and intangible assets acquired and is not deductible for tax purposes. Liabilities assumed included approximately $23 million of restructuring costs associated with the acquisition, $6 million of which related to workforce reduction and the remainder related to excess facilities. As of December 31, 2005, approximately $9 million remained related to excess facilities.

Overture. On October 7, 2003, the Company completed the acquisition of Overture Services, Inc. ("Overture"), a provider of commercial search services on the Internet, including sponsored search services. The Company believed that the combined assets of the Company and Overture would further position it as a leader in the Internet advertising sector. Together, the two companies would be able to provide a diversified suite of integrated marketing solutions, including branding, paid placement, graphical advertisements, text based links, multimedia and contextual advertising. These factors contributed to a purchase price in excess of the fair market value of the net tangible and intangible assets acquired from Overture and as a result, the Company has recorded goodwill in connection with this transaction.

Under the terms of the acquisition agreement, each outstanding share of Overture was exchanged for 1.2216 shares of Yahoo! common stock, representing approximately 79 million shares valued at $1.3 billion and $4.75 per share in cash, which amounted to $309 million in aggregate cash, and together with $136 million related to 19 million stock options exchanged and direct transaction costs of $10 million, resulted in an aggregate purchase price of $1.7 billion. The approximate $309 million of total cash consideration less cash acquired of $161 million resulted in a net cash outlay of $148 million. The value of the Yahoo! common stock was determined based on the average market price of the common stock over the five day period surrounding the date the acquisition was announced in July 2003. The value of the stock options was determined using the Black-Scholes option valuation model.

The allocation of the purchase price to the assets acquired and liabilities assumed based on the fair values was as follows (in thousands):

Cash acquired	$ 160,673
Other tangible assets acquired	237,632
Amortizable intangible assets:	
Customer, affiliate and advertiser related relationships	202,300
Developed technology and patents	134,300
Trade name, trademark and domain name	17,300
Goodwill	1,146,998
Total assets acquired	1,899,203
Liabilities assumed	(234,798)
Deferred stock-based compensation	67,213
Total	$1,731,618

The amortizable intangible assets have useful lives not exceeding five years and a weighted average useful life of approximately 4 years. No amount has been allocated to in-process research and development and $1.1 billion has been allocated to goodwill. Goodwill represents the excess of the purchase price over the fair value of the net tangible and intangible assets acquired and is not deductible for tax purposes. Other tangible assets acquired of approximately $238 million included long-term prepaid traffic acquisition costs paid by Overture to Yahoo! of $30 million. Liabilities assumed of approximately $235 million included a current liability for traffic acquisition costs owed by Overture to Yahoo! of $28 million. Liabilities assumed included approximately $26 million of restructuring costs associated with the acquisition, $18 million of

which related to workforce reduction and the remainder related to excess facilities. As of December 31, 2005, there was no remaining balance related to severance costs or excess facilities.

Acquisitions completed in 2004

3721. On January 2, 2004, the Company completed the acquisition of 3721 Network Software Company Limited ("3721"), a Hong Kong-based software development company. The acquisition combined the Company's global audience and 3721's keyword search technology to enable the Company to continue improving its global search services. These factors contributed to a purchase price in excess of the fair value of net tangible and intangible assets acquired from 3721 and as a result, the Company has recorded goodwill in connection with this transaction.

The total purchase price of approximately $95 million consisted of $92 million in cash consideration, $2 million related to stock options exchanged and direct transaction costs of $1 million. The total cash consideration of approximately $92 million less cash acquired of approximately $7 million resulted in a net cash outlay of $85 million.

The allocation of the purchase price to the assets acquired and liabilities assumed based on the fair values was as follows (in thousands):

Cash acquired	$ 6,917
Other tangible assets acquired	4,498
Amortizable intangible assets:	
Customer and advertiser related relationships	7,600
Developed technology and patents	3,800
Trade name, trademark and domain name	1,000
Goodwill	80,957
Total assets acquired	104,772
Liabilities assumed	(11,186)
Deferred stock-based compensation	1,757
Total	$ 95,343

The amortizable intangible assets have useful lives not exceeding five years and a weighted average useful life of approximately 3 years. No amount has been allocated to in-process research and development and $81 million has been allocated to goodwill. Goodwill represents the excess of the purchase price over the fair value of the net tangible and intangible assets acquired and is not deductible for tax purposes. See Note 4 — "Investments in Equity Interests" for a description of the Company's investment in Alibaba and the related divestiture of 3721.

Kelkoo. On April 5, 2004, the Company completed the acquisition of a majority interest in Kelkoo S.A. ("Kelkoo"), a leading European online comparison shopping service. In July 2004, the Company completed the acquisition of additional interests in Kelkoo, increasing the Company's total ownership interest in Kelkoo to 100 percent. The acquisition expanded the Company's global commerce presence and together with the Company's existing services increased the Company's competitive position in Europe. These factors contributed to a purchase price in excess of the fair value of net tangible and intangible assets acquired from Kelkoo and as a result, the Company has recorded goodwill in connection with this transaction.

The total purchase price of approximately $571 million consisted of $562 million in cash consideration, $6 million in incurred liabilities and direct transaction costs of $3 million. The total cash consideration of approximately $562 million less cash acquired of $39 million resulted in a net cash outlay of $523 million.

The allocation of the purchase price to the assets acquired and liabilities assumed based on the fair values was as follows (in thousands):

Cash acquired	$ 38,817
Other tangible assets acquired	24,068
Amortizable intangible assets:	
Customer, affiliate and advertiser related relationships	36,100
Developed technology and patents	9,100
Trade name, trademark and domain name	61,300
Goodwill	453,555
Total assets acquired	622,940
Liabilities assumed	(51,832)
Total	$571,108

The amortizable intangible assets have useful lives not exceeding five years and a weighted average useful life of approximately 5 years. No amount has been allocated to in-process research and development and $454 million has been allocated to goodwill. Goodwill represents the excess of the purchase price over the fair value of the net tangible and intangible assets acquired and is not deductible for tax purposes.

Musicmatch. On October 18, 2004, the Company completed the acquisition of Musicmatch, Inc. ("Musicmatch"), a leading provider of personalized music software and services. The acquisition significantly increased the Company's presence in the digital music business and together with the Company's existing music services, Yahoo! Music, provided one of the most comprehensive suite of music services for users, marketers, artists and record labels. These factors contributed to a purchase price in excess of the fair value of net tangible and intangible assets acquired from Musicmatch and as a result, the Company has recorded goodwill in connection with this transaction.

The total purchase price of $158 million consisted of $157 million in cash consideration and direct transaction costs of $1 million. The $157 million of total cash consideration less cash acquired of $3 million resulted in a net cash outlay of $154 million.

The allocation of the purchase price to the assets acquired and liabilities assumed based on the fair values was as follows (in thousands):

Cash acquired	$ 2,516
Other tangible assets acquired	8,591
Amortizable intangible assets:	
Customer contracts and related relationships	1,700
Developed technology and patents	18,100
Trade name, trademark and domain name	1,100
Goodwill	171,633
Total assets acquired	203,640
Liabilities assumed	(45,317)
Total	$158,323

The amortizable intangible assets have useful lives of three years. No amount has been allocated to in-process research and development and $172 million has been allocated to goodwill. Goodwill represents the excess of the purchase price over the fair value of the net tangible and intangible assets acquired and is not deductible for tax purposes.

Other Acquisitions — Business Combinations. During the year ended December 31, 2004, the Company acquired three other companies which were accounted for as business combinations. The total estimated purchase price for these three acquisitions was approximately $49 million and consisted of $46 million in cash consideration, $2 million related to stock options exchanged, and $1 million direct transaction costs. The total cash consideration of $46 million less cash acquired of approximately $2 million resulted in a net cash outlay of $44 million. Of the purchase price, $41 million was allocated to goodwill, $14 million to amortizable intangible assets and $6 million to net assumed liabilities. No amounts have been allocated to in-process research and development. Goodwill represents the excess of the purchase price over the fair value of the net tangible and intangible assets acquired and is not deductible for tax purposes.

Acquisitions completed in 2005

Verdisoft Corporation. On February 11, 2005 the Company acquired Verdisoft Corporation ("Verdisoft"), a software development company. The acquisition of Verdisoft enhanced the Company's platform for delivering content and services to mobile devices as part of the Company's strategy to provide users with seamless access to its network. The transaction was treated as an asset acquisition for accounting purposes and therefore no goodwill was recorded. The estimated purchase price was approximately $58 million and consisted of $54 million in cash consideration, $3 million related to stock options exchanged and $1 million of direct transaction costs. In connection with the acquisition, the Company also issued approximately 1 million shares of restricted stock valued at $35 million that will be recognized as expense over three years. For accounting purposes, approximately $93 million was allocated to amortizable intangible assets, $37 million to liabilities, primarily deferred income tax liabilities, and $2 million to deferred stock-based compensation. The amortizable intangible assets have useful lives not exceeding four years and a weighted average useful life of approximately 3 years.

Yahoo! Europe and Yahoo! Korea. In November 1996, the Company entered into joint ventures with SOFTBANK Corp., including its consolidated affiliates ("SOFTBANK") whereby separate companies were formed in the United Kingdom, France and Germany, (collectively "Yahoo! Europe") which established and managed local versions of Yahoo! in those countries. In August 1997, the Company entered into a similar joint venture with SOFTBANK in Korea. Prior to November 2005, the Company had a majority share of approximately 70 percent in each of the Yahoo! Europe entities and 67 percent in Yahoo! Korea and therefore the results of these entities were included in the Company's consolidated financial statements, with minority interests separately presented on the consolidated statements of operations and consolidated balance sheets. On November 23, 2005, the Company purchased SOFTBANK's remaining shares in the joint ventures giving the Company 100 percent ownership in these entities.

The total purchase price of $501 million consisted of $500 million in cash consideration and direct transaction costs of $1 million.

The allocation of the purchase price to the assets acquired and liabilities assumed based on the fair values was as follows (in thousands):

Net tangible assets acquired	$ 52,484
Amortizable intangible assets:	
Customer contracts and related relationships	30,561
Developed technology and patents	6,570
Trade name, trademark and domain name	50,121
Goodwill	387,771
Total assets acquired	527,507
Deferred income taxes	(26,633)
Total	$500,874

The amortizable intangible assets have useful lives not exceeding five years and a weighted average life of approximately 4 years. No amount has been allocated to in-process research and development and $388 million has been allocated to goodwill. Goodwill represents the excess of the purchase price over the fair value of the net tangible and intangible assets acquired and is not deductible for tax purposes.

Other Acquisitions — Business Combinations. During the year ended December 31, 2005, the Company acquired four other companies which were accounted for as business combinations. The total purchase for these four acquisitions was approximately $79 million and consisted of $73 million in cash consideration, $3 million related to stock options exchanged and $3 million of direct transaction costs. The total cash consideration of $73 million less cash acquired of $3 million resulted in net cash outlay of $70 million. Of the purchase price, $58 million was allocated to goodwill, $32 million to amortizable intangible assets and $11 million to net assumed liabilities. Approximately $1 million was allocated to in-process research and development and expensed in the consolidated statements of operations. Goodwill represents the excess of the purchase price over the fair value of the net tangible and intangible assets acquired and is not deductible for tax purposes.

The purchase price allocations for these acquisitions are preliminary and subject to revision as more detailed analyses are completed and additional information on the fair value of assets and liabilities becomes available. Any change in the fair value of the net assets of the acquired companies will change the amount of the purchase price allocable to goodwill.

In each of the three years ended December 31, 2005 the Company also completed immaterial asset acquisitions that did not qualify as business combinations.

Pro forma results of operations have not been presented for the acquisitions completed during the years ended December 31, 2004 and 2005 as the results of the acquired companies, not already consolidated, either individually or in the aggregate were not material to the Company's financial results before the acquisitions.

Note 4 INVESTMENTS IN EQUITY INTERESTS

As of December 31, *Investments in equity interests* consisted of the following (dollars in thousands):

	2004	2005	Percent Ownership
Alibaba	$ —	$1,408,716	46%
Yahoo! Japan	239,803	349,685	34%
Total	$239,803	$1,758,401	

Equity Investment in Alibaba. On October 23, 2005, the Company acquired approximately 46 percent of the outstanding common stock of Alibaba, which represents approximately 40 percent on a fully diluted basis, in exchange for $1.0 billion in cash, the contribution of the Company's China based businesses, including 3721 ("Yahoo China") and direct transaction costs of $8 million. Pursuant to the terms of a shareholder agreement, the Company has an approximate 35 percent voting interest in Alibaba, with the remainder of its voting rights subject to a voting agreement with Alibaba management. Other investors in Alibaba include SOFTBANK.

Through this transaction, the Company has combined its leading search capabilities with Alibaba's leading online marketplace and online payment system and Alibaba's strong local presence, expertise and vision in the China market. These factors contributed to a purchase price in excess of the Company's share of the fair value of Alibaba's net tangible and intangible assets acquired resulting in goodwill.

The purchase price was based on acquiring a 40 percent equity interest in Alibaba on a fully diluted basis. The Company's equity interest in Alibaba may be diluted from approximately 46 percent to 40 percent

upon the conversion of Alibaba's outstanding convertible debt and exercises of Alibaba's employee stock options. In allocating the excess of the carrying value of its investment in Alibaba over its proportionate share of the net assets of Alibaba, the Company allocated a portion of the excess to goodwill to account for the estimated reductions in the carrying value of the investment in Alibaba that may occur as the Company's equity interest is diluted from approximately 46 percent to 40 percent.

The difference between the Company's carrying value of its investment in Alibaba and its proportionate share of the net assets of Alibaba is summarized as follows (in thousands):

Carrying value of investment in Alibaba	$1,408,716
Proportionate share of net assets of Alibaba	894,596
Excess of carrying value of investment over proportionate share of net assets	$ 514,120
The excess carrying value has been primarily assigned to:	
Goodwill	$ 430,590
Amortizable intangible assets	86,737
Deferred income taxes	(3,207)
Total	$ 514,120

The amortizable intangible assets have useful lives not exceeding seven years and a weighted average useful life of approximately 5 years. No amount has been allocated to in-process research and development. The preliminary allocation is subject to revision as more detailed analysis is completed and additional information on the assets and liabilities of Alibaba as of the closing date becomes available. Any change in the net assets of Alibaba will change the amount of the purchase price allocable to goodwill. Goodwill is not deductible for tax purposes.

The investment in Alibaba is being accounted for using the equity method and the total investment, including net tangible assets, identifiable intangible assets and goodwill are classified as part of the Investment in equity interests balance on the consolidated balance sheets. The Company will record its share of the results of Alibaba and any related amortization expense, one quarter in arrears within earnings in equity interests. Following the acquisition date, Yahoo! China has not been included in the Company's consolidated results but will be included within earnings in equity interests to the extent of the Company's continued ownership interest in Alibaba, commencing in the first quarter of 2006. The revenues and operating income of Yahoo! China were not material to the consolidated results of the Company for the years ended December 31, 2003 and 2004 and the period from January 1, 2005 to October 23, 2005, the date of the divestiture of Yahoo! China. In connection with the transaction, the Company also recorded a non-cash gain of $338 million in other income, net based on the difference between the fair value of Yahoo! China and its carrying value adjusted for the Company's continued ownership in the newly combined entity. As described above, the Company's interest in Alibaba may be diluted from approximately 46 percent to 40 percent. The Company will recognize further non-cash gains as such dilution occurs.

Equity Investment in Yahoo! Japan. During April 1996, the Company signed a joint venture agreement with SOFTBANK, which was amended in September 1997, whereby Yahoo! Japan Corporation ("Yahoo! Japan") was formed. Yahoo! Japan was formed to establish and manage a local version of Yahoo! in Japan. The Company also has commercial arrangements with Yahoo! Japan, consisting of services, including algorithmic search services and sponsored search services and the related traffic acquisition costs and license fees. Due to the acquisition of Overture, traffic acquisition costs have increased resulting in the net cost of these arrangements of approximately $67 million and $171 million for the years ended December 31, 2004 and 2005, respectively, compared to net revenues of $9 million for the year ended December 31, 2003. In the second quarter of 2005, the Company received a cash dividend in the amount

of $11 million which was recorded as a reduction in the Company's investment in Yahoo! Japan. As of December 31, 2004 and 2005, the Company had a net payable balance to Yahoo! Japan of approximately $30 million and $7 million, respectively.

The investment in Yahoo! Japan is being accounted for using the equity method. The fair value of the Company's approximate 34 percent ownership in Yahoo! Japan, based on the quoted stock price, was approximately $15 billion as of December 31, 2005.

Prior to and during 2001, Yahoo! Japan acquired the Company's equity interests in certain entities in Japan for total consideration of approximately $65 million, paid partially in shares of Yahoo! Japan common stock and partially in cash. As a result of the acquisition, the Company increased its investment in Yahoo! Japan, which resulted in approximately $41 million of goodwill to be amortized over seven years. The amortization ceased upon the adoption of SFAS 142 on January 1, 2002. The carrying amount of the Company's investment in Yahoo! Japan differs from the amount of the underlying equity in net assets of Yahoo! Japan primarily as a result of this goodwill.

As of December 31, 2005 and 2004, the Company had $304 million and $176 million, respectively, included in retained earnings relating to its investment in Yahoo! Japan.

The Company records its share of the results of Yahoo! Japan one quarter in arrears within earnings in equity interests. The following table presents Yahoo! Japan's condensed financial information, as derived from the Yahoo! Japan financial statements for the 12 months ended September 30, 2003, 2004, and 2005 and as of September 30, 2004 and 2005 (in thousands):

	Twelve Months Ended September 30,		
	2003	2004	2005
Operating data:			
Revenues	$500,091	$868,281	$1,367,247
Gross profit	$462,352	$810,114	$1,251,599
Income from operations	$262,393	$470,681	$ 656,167
Net income	$145,720	$290,576	$ 382,287

	September 30,	
	2004	2005
Balance sheet data:		
Current assets	$622,794	$900,149
Long-term assets	$291,566	$469,077
Current liabilities	$192,761	$306,441
Long-term liabilities	$ 22,803	$ 19,663

The differences between United States and Japanese generally accepted accounting principles did not materially impact the amounts reflected in the Company's financial statements.

Note 5 GOODWILL

The changes in the carrying amount of goodwill for the years ended December 31, 2004 and 2005 are as follows (in thousands):

	United States	International	Total
Balance as of January 1, 2004	$1,710,998	$ 94,563	$1,805,561
Acquisitions and other [1]	204,911	509,383	714,294
Foreign currency translation adjustments	—	31,102	31,102
Reclassification [2]	(242,490)	242,490	—
Balance as of December 31, 2004	1,673,419	877,538	2,550,957
Acquisitions and other [1]	47,333	343,556	390,889
Foreign currency translation adjustments	—	(46,289)	(46,289)
Balance as of December 31, 2005	$1,720,752	$1,174,805	$2,895,557

(1) Other primarily includes certain purchase price adjustments that affect existing goodwill. In the year ended December 31, 2005, this also includes a reduction of $59 million of goodwill related to the divestiture of Yahoo! China. See Note 4 — "Investments in Equity Interests" for additional information.

(2) Reclassification reflects the allocation of goodwill related to the Overture acquisition to the Company's segments.

Note 6 INTANGIBLE ASSETS, NET

The following table summarizes the Company's intangible assets, net (in thousands):

	December 31, 2004		
	Gross carrying amount	Accumulated amortization [1]	Net
Customer, affiliate and advertiser related relationships	$319,585	$(114,553)	$205,032
Developed technology and patents	226,107	(54,269)	171,838
Trademark, trade name and domain name	137,800	(34,004)	103,796
Total intangible assets, net	$683,492	$(202,826)	$480,666

	December 31, 2005		
	Gross carrying amount	Accumulated amortization [1]	Net
Customer, affiliate and advertiser related relationships	$348,111	$(188,669)	$159,442
Developed technology and patents	371,610	(119,094)	252,516
Trademark, trade name and domain name	183,536	(60,879)	122,657
Total intangible assets, net	$903,257	$(368,642)	$534,615

(1) Foreign currency translation adjustments, reflecting movement in the currencies of the underlying entities, totaled approximately $10 million as of December 31, 2004 and $1 million as of December 31, 2005.

The intangible assets are all amortizable and have original estimated useful lives as follows:

- Customer, affiliate and advertiser related relationships — two to seven years;
- Developed technology and patents — two to five years; and
- Trademark, trade name and domain name — four to seven years.

The Company recognized amortization expense on intangible assets, including amortization expense of developed technology and patents included in the cost of revenues, of approximately $54 million, $146 million and $173 million for 2003, 2004, and 2005, respectively. Based on the current amount of intangibles subject to amortization, the estimated amortization expense for each of the succeeding five

years is as follows: 2006: $214 million; 2007: $171 million; 2008: $116 million; 2009: $25 million and 2010: $9 million.

Note 7 CONSOLIDATED FINANCIAL STATEMENT DETAILS

Other income, net

Other income, net for 2003, 2004, and 2005 was as follows (in thousands):

	Years Ended December 31,		
	2003	2004	2005
Interest and investment income	$47,202	$ 60,830	$ 125,122
Investment gains (losses), net [1]	(1,223)	415,125	967,327
Gain on divestiture of Yahoo! China [2]	—	—	337,965
Other	1,527	20,488	5,443
Total other income, net	$47,506	$496,443	$1,435,857

(1) See Note 14 — "Litigation Settlement" for additional information related to the investment gains in the years ended December 31, 2004 and 2005. Also included is an impairment loss of $28 million on an available-for-sale equity investment in the year ended December 31, 2005.

(2) See Note 4 — "Investments in Equity Interests" for additional information related to the gain on the divestiture of Yahoo! China for the year ended December 31, 2005.

Investment gains (losses), net include realized investment gains, realized investment losses, and impairment charges related to declines in values of publicly traded securities and securities of privately held companies judged to be other than temporary.

Prepaid expenses and other current assets

As of December 31, *Prepaid expenses and other current assets* consisted of the following (in thousands):

	2004	2005
Prepaid expenses	$72,622	$ 70,706
Deferred income taxes (Note 10)	3,958	56,085
Other	21,927	40,185
Total prepaid expenses and other current assets	$98,507	$166,976

Property and equipment, net

As of December 31, *Property and equipment, net* consisted of the following (in thousands):

	2004	2005
Land	$ 51,061	$ 51,061
Buildings	191,183	192,266
Leasehold improvements	62,488	73,054
Computers and equipment	548,167	838,357
Furniture and fixtures	54,066	63,955
Assets not yet in use	12,740	48,624
	919,705	1,267,317
Less: accumulated depreciation and amortization	(388,009)	(569,795)
Total property and equipment, net	$ 531,696	$ 697,522

Other assets

As of December 31, *Other assets* consisted of the following (in thousands):

	2004	2005
Deferred income taxes (Note 10)	$195,916	$21,746
Investments in privately-held companies	12,992	2,920
Other	33,121	32,526
Total other assets	$242,029	$57,192

Accrued expenses and other current liabilities

As of December 31, *Accrued expenses and other current liabilities* consisted of the following (in thousands):

	2004	2005
Accrued content, connection, traffic acquisition and other costs	$220,661	$303,167
Deferred income taxes (Note 10)	195,916	953
Accrued compensation and related expenses	168,722	224,793
Accrued taxes payable	51,857	36,285
Accrued professional service expenses	48,408	53,983
Accrued sales and marketing related expenses	47,830	61,519
Accrued acquisition-related costs	34,298	34,008
Other	85,423	112,881
Total accrued expenses and other current liabilities	$853,115	$827,589

Other long-term liabilities

As of December 31, *Other long-term liabilities* consisted of the following (in thousands):

	2004	2005
Deferred income taxes (Note 10)	$35,771	$243,575
Other	136	5
Total other long-term liabilities	$35,907	$243,580

Accumulated other comprehensive income (loss)

As of December 31, the components of *Accumulated other comprehensive income (loss)* were as follows (in thousands):

	2003	2004	2005
Unrealized gains and losses on available-for-sale securities, net of tax	$3,889	$475,314	$(16,218)
Foreign currency translation	(291)	60,422	(19,747)
Accumulated other comprehensive income (loss)	$3,598	$535,736	$(35,965)

Note 8 INVESTMENTS

The following tables summarize the investments in available-for-sale securities (in thousands):

	December 31, 2004			
	Gross Amortized Costs	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
United States Government and agency securities	$ 991,952	$ 189	$ (6,179)	$ 985,962
Municipal bonds	9,160	11	(20)	9,151
Corporate bonds	1,132,667	1,670	(5,948)	1,128,389
Auction rate securities	795,037	—	—	795,037
Corporate equity securities	13,611	802,730	(219)	816,122
Total investments in available-for-sale securities	$2,942,427	$804,600	$(12,366)	$3,734,661

	December 31, 2005			
	Gross Amortized Costs	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
United States Government and agency securities	$1,057,960	$ 29	$(13,210)	$1,044,779
Municipal bonds	9,760	—	(166)	9,594
Corporate debt securities	1,528,282	127	(12,627)	1,515,782
Corporate equity securities	31,175	—	(1,168)	30,007
Total investments in available-for-sale securities	$2,627,177	$156	$(27,171)	$2,600,162

	December 31,	
	2004	2005
Reported as:		
Marketable debt securities	$1,875,964	$1,131,141
Marketable equity securities	812,288	—
Long-term marketable debt securities	1,042,575	1,439,014
Other assets	3,834	30,007
Total	$3,734,661	$2,600,162

Auction rate securities are securities that are structured with short-term reset dates of generally less than 90 days but with maturities in excess of 90 days. At the end of the reset period, investors can sell or continue to hold the securities at par. These securities are classified in the table below based on their legal stated maturity dates. As of December 31, 2005, the Company did not hold any auction rate securities. Available-for-sale securities included in Cash and cash equivalents on the consolidated balance sheets are not included in the table above as the gross unrealized gains and losses were immaterial for 2005 and 2004 with respect to these securities.

The contractual maturities of available-for-sale debt securities are as follows (in thousands):

	December 31,	
	2004	2005
Due within one year	$1,080,927	$1,131,141
Due after one year through five years	1,042,575	1,426,799
Due after five years	795,037	12,215
Total available-for-sale debt securities	$2,918,539	$2,570,155

The following tables show all investments in an unrealized loss position for which an other-than-temporary impairment has not been recognized and the related gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position (in thousands):

	December 31, 2004					
	Less than 12 Months		12 Months or Greater		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
United States Government and agency securities	$ 668,465	$(4,238)	$159,590	$(1,941)	$ 828,055	$ (6,179)
Municipal bonds	—	—	2,899	(20)	2,899	(20)
Corporate bonds	689,859	(3,659)	209,439	(2,289)	899,298	(5,948)
Auction rate securities	—	—	—	—	—	—
Corporate equity securities	3,834	(219)	—	—	3,834	(219)
Total investments in available-for-sale securities	$1,362,158	$(8,116)	$371,928	$(4,250)	$1,734,086	$(12,366)

	December 31, 2005					
	Less than 12 Months		12 Months or Greater		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
United States Government and agency securities	$ 539,875	$ (4,790)	$474,856	$ (8,420)	$1,014,731	$(13,210)
Municipal bonds	9,594	(166)	—	—	9,594	(166)
Corporate debt securities	1,072,961	(7,545)	356,842	(5,082)	1,429,803	(12,627)
Corporate equity securities	—	—	2,885	(1,168)	2,885	(1,168)
Total investments in available-for-sale securities	$1,622,430	$(12,501)	$834,583	$(14,670)	$2,457,013	$(27,171)

The Company's investment portfolio consists of government and high-quality corporate securities. Investments in both fixed rate and floating rate interest earning instruments carry a degree of interest rate risk. Fixed rate securities may have their fair market value adversely impacted due to a rise in interest rates, while floating rate securities may produce less income than expected in interest rates fall. The longer the term of the securities, the more susceptible they are to changes in market rates of interest and yields on bonds. Investments are reviewed periodically to identify possible other-than-temporary impairment. When evaluating the investments, the Company reviews factors such as the length of time and extent to which fair value has been below cost basis, the financial condition of the issuer and the Company's ability and intent to hold the investment for a period of time which may be sufficient for anticipated recovery in market value. The Company has the intent and ability to hold these securities for a reasonable period of time sufficient for a forecasted recovery of fair value up to (or beyond) the initial cost of the investment. The Company expects to realize the full value of all of these investments upon maturity or sale.

Note 9 LONG-TERM DEBT

In April 2003, the Company issued $750 million of zero coupon senior convertible notes (the "Notes") due April 2008, which resulted in net proceeds to the Company of approximately $733 million after transaction fees of $17 million, which have been deferred and are included on the consolidated balance sheets in long-term other assets. As of December 31, 2005, $8 million of the transaction fees remained to be amortized. The Notes were issued at par and bear no interest. The Notes are convertible into Yahoo! common stock at a conversion price of $20.50 per share, which would result in the issuance of an aggregate of approximately 37 million shares, subject to adjustment upon the occurrence of specified events. Each

$1,000 principal amount of the Notes will initially be convertible into 48.78 shares of Yahoo! common stock.

The Notes are convertible prior to the final maturity date (1) during any fiscal quarter if the closing sale price of the Company's common stock for at least 20 trading days in the 30 trading-day period ending on the last trading day of the immediately preceding fiscal quarter exceeded 110 percent of the conversion price on that 30th trading day, (2) during the period beginning January 1, 2008 through the maturity date, if the closing sale price of the Company's common stock on the previous trading day was 110 percent or more of the then current conversion price and (3) upon specified corporate transactions. Upon conversion, the Company has the right to deliver cash in lieu of common stock. The Company may be required to repurchase all of the Notes following a fundamental change of the Company, such as a change of control, prior to maturity at face value. The Company may not redeem the Notes prior to their maturity.

As of December 31, 2005, the market price condition for convertibility of the Notes was satisfied with respect to the fiscal quarter beginning January 1, 2006 and ending on March 31, 2006. During this period holders of the Notes will be able to convert their Notes into shares of Yahoo! common stock at the rate of 48.78 shares of Yahoo! common stock for each Note. The Notes will also be convertible into shares of Yahoo! common stock in subsequent fiscal quarters, if any, with respect to which the market price condition for convertibility is met.

As of December 31, 2005, the fair value of the Notes was approximately $1.4 billion based on quoted market prices. The shares issuable upon conversion of the Notes have been included in the computation of diluted net income per share since the Notes were issued.

Note 10 Income Taxes

The components of income before income taxes, earnings in equity interests and minority interests are as follows (in thousands):

	Years Ended December 31,		
	2003	2004	2005
United States	$322,863	$1,172,480	$2,047,284
Foreign [1]	20,309	12,544	496,298
Income before income taxes, earnings in equity interests and minority interests	$343,172	$1,185,024	$2,543,582

[1] Includes a non-cash gain of $338 million related to the divestiture of Yahoo! China in connection with the Alibaba transaction (see Note 4 — "Investments in Equity Interests.") The majority of the tax on the gain was provided in the United States as the gain was not taxable in any foreign jurisdiction.

The provision (benefit) for income taxes is composed of the following (in thousands):

	Years Ended December 31,		
	2003	2004	2005
Current:			
United States federal	$121,758	$409,969	$508,175
State	25,584	83,632	184,296
Foreign	14,589	17,782	42,625
Total current provision for income taxes	161,931	511,383	735,096
Deferred:			
United States federal	(13,276)	(62,620)	37,058
State	(1,631)	(8,580)	4,996
Foreign	—	(2,217)	(9,334)
Total deferred provision (benefit) for income taxes	(14,907)	(73,417)	32,720
Provision for income taxes	$147,024	$437,966	$767,816

The provision for income taxes differs from the amount computed by applying the federal statutory income tax rate to income before income taxes as follows (in thousands):

	Years Ended December 31,		
	2003	2004	2005
Income tax at the United States federal statutory rate of 35 percent	$120,112	$414,758	$ 890,254
State income taxes, net of federal benefit	15,184	49,920	113,685
Change in valuation allowance	8,516	(40,612)	16,342
Capital loss on subsidiary restructuring transaction [1]	—	—	(248,284)
Other	3,212	13,900	(4,181)
Provision for income taxes	$147,024	$437,966	$ 767,816

[1] During 2005, the Company completed a taxable liquidation of a subsidiary. The transaction gave rise to a capital loss for tax purposes, resulting in a tax benefit of approximately $248 million.

Deferred income taxes reflect the tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. The components of deferred income tax assets and liabilities are as follows (in thousands):

	December 31,	
	2004	2005
Deferred income tax assets:		
Net operating loss and tax credit carryforwards	$ 1,436,144	$ 1,277,269
Non-deductible reserves and expenses	406,488	445,355
Gross deferred income tax assets	1,842,632	1,722,624
Valuation allowance	(1,353,748)	(1,507,848)
Realizable deferred income tax assets	$ 488,884	$ 214,776
Deferred income tax liabilities:		
Unrealized investment gains	$ (315,274)	$ —
Purchased intangible assets	(197,794)	(211,446)
Investments in equity interests	—	(131,927)
Other	(7,629)	(38,100)
Gross deferred income tax liabilities	$ (520,697)	$ (381,473)
Net deferred income tax liabilities	$ (31,813)	$ (166,697)

As of December 31, 2005, the Company's federal and state net operating loss carryforwards for income tax purposes were approximately $2.7 billion and $1.0 billion, respectively. If not utilized, the federal net operating loss carryforwards will begin to expire in 2008, and approximately $422 million of the state net operating loss carryforwards will expire in 2006. The Company's federal and state research tax credit carryforwards for income tax purposes are approximately $94 million and $99 million, respectively. If not utilized, the federal research tax credit carryforwards will begin to expire in 2010. The state research tax credit carryforwards will not expire.

The Company has a valuation allowance of approximately $1.5 billion as of December 31, 2005 to reduce deferred income tax assets to the amount that is more likely than not to be realized in future periods. In evaluating the Company's ability to recover its deferred income tax assets the Company considers all available positive and negative evidence, including operating results, ongoing tax planning and forecasts of future taxable income on a jurisdiction by jurisdiction basis.

Approximately $966 million of the deferred income tax asset balance as of December 31, 2005 pertains to certain net operating loss carryforwards and credit carryforwards resulting from the exercise of employee stock options. Approximately $215 million of the deferred income tax asset balance relates to net operating losses acquired in certain business combinations and will result in adjustments to goodwill if and when recognized. Approximately $96 million of the deferred income tax asset balance relates to foreign net operating loss and credit carryforwards and will reduce the provision for income taxes if and when recognized. The benefit of the remaining $1,197 million of unrealized deferred income tax assets will be accounted for as a credit to additional paid-in capital if and when recognized.

The Company provides United States income taxes on the earnings of foreign subsidiaries unless the subsidiaries' earnings are considered indefinitely reinvested outside the United States. As of December 31, 2005, the Company had unrecorded deferred income tax liabilities of approximately $16 million related to $45 million of cumulative net undistributed earnings of foreign subsidiaries. These earnings are considered indefinitely invested in operations outside the United States, as the Company intends to utilize these amounts to fund future expansion of its international operations.

Note 11 STOCKHOLDERS' EQUITY

Stockholder Rights Plan. In March 2001, the Company adopted a Stockholder Rights Plan. Under the plan, the rights were distributed as a dividend at the rate of one Right for each share of common stock held by stockholders of record as of the close of business on March 20, 2001. The Stockholder Rights Plan was not adopted in response to any effort to acquire control of the Company. The rights will expire on March 1, 2011.

Stock Repurchase Programs. In March 2001, the Company's Board of Directors authorized the Company to repurchase up to $500 million of its outstanding shares of common stock over the following two years, depending on market conditions, share price and other factors. In March 2003, the Company's Board of Directors authorized a two-year extension of this stock repurchase program until March 2005. Under this program, from March 2001 through December 31, 2004, the Company repurchased 32.9 million shares of common stock at an average price of $4.86 per share for total consideration of $160 million. During this period, of the shares repurchased, 32.1 million shares were purchased from SOFTBANK at an average price of $4.84 per share. During the three months ended March 31, 2005, the Company repurchased an additional 4.9 million shares in the open market, at an average price of $33.60 per share, for total consideration of $165 million. This stock repurchase program has expired.

In March 2005, the Company's Board of Directors authorized a new stock repurchase program for the Company to repurchase up to $3.0 billion of its outstanding shares of common stock over the next five years, depending on market conditions, share price and other factors. Under this program in the year

ended December 31, 2005, the Company repurchased 6.8 million shares of common stock at an average price of $32.90 per share, for total consideration of $223 million.

In total for the year ended December 31, 2005, under the expired and current stock repurchase programs, the Company repurchased 11.7 million shares of common stock at an average price of $33.20 per share, for total consideration of $388 million. On a cumulative basis, the Company has repurchased 44.6 million shares, which are recorded as part of treasury stock. Treasury stock is accounted for under the cost method.

Structured Stock Repurchases. During the year ended December 31, 2004, the Company entered into $150 million in structured stock repurchase transactions which settle in cash or stock depending on the market price of Yahoo!'s common stock on the date of maturity. Of these transactions, $75 million settled in 2004 resulting in the Company receiving $80 million in cash. The remaining $75 million settled in 2005, resulting in the Company receiving $82 million in cash.

During the year ended December 31, 2005 the Company entered into $1,395 million in structured stock repurchase transactions. Of these transactions, $650 million settled in 2005 resulting in the Company receiving $702 million in cash.

As of December 31, 2005, the outstanding structured stock repurchase tranches totaling $745 million will mature as follows:

- In the first quarter of 2006, a $250 million tranche will mature and if the market price of Yahoo! common stock is at or above $33.98 the Company will have its investment returned with a premium. If the market price is below $33.98 the Company will repurchase 8.0 million shares of its common stock.
- In the first quarter of 2006, a $110 million tranche will mature and if the market price of Yahoo! common stock is at or above $38.66 the Company will have its investment returned with a premium. If the market price is below $38.66 the Company will repurchase 3.0 million shares of its common stock.
- In the second quarter of 2006, a $250 million tranche will mature and if the market price of Yahoo! common stock is at or above $33.99 the Company will have its investment returned with a premium. If the market price is below $33.99 the Company will repurchase 8.3 million shares of its common stock.
- In the second quarter of 2006, a $135 million tranche will mature and if the market price of Yahoo! common stock is at or above $38.66 the Company will have its investment returned with a premium. If the market price is below $38.66 the Company will repurchase 3.8 million shares of its common stock.

The outstanding structured stock repurchase transactions as of the balance sheet dates are recorded in stockholders' equity on the consolidated balance sheets. See Note 17 — "Subsequent Events" for additional information.

Note 12 EMPLOYEE BENEFITS

Benefit Plans. The Company maintains a Yahoo! Inc. 401(k) Plan (the "401(k) Plan") for its full-time employees in the United States. The 401(k) Plan allows employees of the Company to contribute up to the Internal Revenue Code prescribed maximum amount. Employees may elect to contribute from 1 percent to 50 percent of their annual compensation to the 401(k) Plan. The Company matches employee contributions at a rate of 25 percent. Employee contributions are fully vested, whereas vesting in matching Company contributions occurs at a rate of 33 percent per year of employment. During 2003, 2004, and 2005, the Company's contributions to the 401(k) Plan amounted to approximately $5 million, $8 million

and $12 million, respectively. The Company also contributed approximately $3 million, $5 million, and $7 million to its other benefit plans outside of the United States for 2003, 2004, and 2005, respectively.

Stock Option Plans. The Company's 1995 Stock Plan and stock option plans assumed through acquisitions are collectively referred to as the "Plans."

The Plans provide for the issuance of equity-based awards to employees, including executive officers and consultants. Options granted under the 1995 Stock Plan before May 19, 2005 generally expire ten years after the grant date and options granted after May 19, 2005 generally expire seven years after the grant date. Options generally become exercisable over a four-year period based on continued employment and vest either monthly, quarterly, semi-annually, or annually. The termination date of the 1995 Stock Plan is May 2013. During the year, the 1995 Stock Plan was amended to increase the number of shares of common stock available for award grants by 80 million shares to 654 million shares. The 1995 Stock Plan permits the granting of incentive stock options, non-statutory stock options, restricted stock, restricted stock units, stock appreciation rights, indexed options and dividend equivalents. Shares available for future grants under the Plans as of December 31, 2005 totaled approximately 88 million shares.

The 1996 Directors' Stock Option Plan (the "Directors' Plan") provides for the issuance of up to approximately 9 million non-statutory stock options to non-employee directors of the Company. Options granted under the Directors' Plan vest in equal monthly installments over four years for initial grants to new directors and over four years for annual grants, with 25 percent of such options vesting on the one-year anniversary of the date of grant, with the remaining options vesting in equal monthly installments over the 36-month period thereafter. The termination date of the Directors' Plan is April 2015. The Directors' Plan provides for an initial grant to outside Directors of 100,000 options and an annual grant to outside Directors of 50,000 options. Shares available for future grants under the Directors' Plan as of December 31, 2005 totaled approximately 5 million shares.

Activity under the Company's stock option plans is summarized as follows (in thousands, except per share amounts):

	Options Outstanding	Weighted Average Exercise Price per Share
Balance as of December 31, 2002	264,968	$18.41
Options assumed	21,630	17.39
Options granted	41,212	17.60
Options exercised	(48,706)	6.94
Options canceled	(31,474)	27.14
Balance as of December 31, 2003	247,630	19.32
Options assumed	224	5.77
Options granted	40,189	31.07
Options exercised	(59,463)	10.36
Options canceled	(15,879)	24.22
Balance as of December 31, 2004	212,701	23.67
Options assumed	193	0.63
Options granted	33,403	36.39
Options exercised	(50,920)	13.44
Options canceled	(12,683)	33.93
Balance as of December 31, 2005	182,694	$28.11

The following table summarizes information concerning outstanding and exercisable options as of December 31, 2005 (in thousands, except years and per share amounts):

	Options Outstanding			Options Exercisable	
Range of Exercise Prices per Share	Number Outstanding	Average Remaining Contractual Life (in years)	Weighted Average Exercise Price per Share	Number Exercisable	Weighted Average Exercise Price per Share
$0.02 - $3.37	2,688	2.2	$ 2.35	2,593	$ 2.41
$3.48 - $7.93	17,096	5.6	5.52	15,123	5.39
$7.94 - $15.00	30,310	6.2	10.56	20,903	10.92
$15.02 - $20.85	25,048	7.5	19.82	13,715	19.96
$20.96 - $30.00	21,315	5.9	27.29	15,608	27.92
$30.15 - $35.95	31,106	6.9	34.30	9,116	35.01
$36.13 - $40.68	37,291	7.2	38.09	12,928	37.68
$41.09 - $46.37	4,977	4.2	43.28	4,268	43.42
$47.13 - $52.75	365	4.4	51.86	365	51.86
$53.14 - $292.07	12,498	4.2	73.21	12,492	73.20
Total	182,694	6.4	$28.11	107,111	$27.55

The weighted average fair value of options granted in the years ended December 31, 2003, 2004, and 2005 was $6.87, $12.09 and $11.60 per share, respectively.

Options to purchase approximately 128 million shares and 119 million shares were exercisable as of December 31, 2003 and 2004, respectively. The weighted average exercise prices per share for options exercisable as of December 31, 2003 and 2004 were $24.63 and $26.46, respectively.

Restricted Stock. The 1995 Stock Plan permits the granting of restricted stock and restricted stock units, collectively referred to as "restricted stock awards". The 1995 Stock Plan permits the granting of restricted stock awards either alone, in addition to, or in tandem with other equity-based awards made by the Company. Rights of repurchase on restricted stock awards grants generally lapse upon meeting certain performance-based milestones, or passage of time, or a combination of both. Restricted stock award grants are generally measured at fair value on the date of grant based on the number of shares granted and the quoted price of the Company's common stock. Such value is recognized as an expense over the corresponding service period. Restricted stock awards that have performance criteria are subject to variable accounting treatment. Approximately 0.4 million, 0.4 million, and 7 million shares of restricted stock awards were granted during 2003, 2004, and 2005, respectively, with average fair market values of $20.58, $34.99, and $36.86 per share on the date of grant.

Employee Stock Purchase Plan. The Company has an Employee Stock Purchase Plan (the "Purchase Plan"), which allows employees to purchase shares of the Company's common stock through payroll deductions of up to 15 percent of their annual compensation up to certain Internal Revenue Code prescribed maximums. The price of the common stock purchased under the Purchase Plan is equal to 85 percent of the lower of the fair market value of the common stock on the commencement date of each 24-month offering period or the specified purchase date. The Purchase Plan provides for the issuance of a maximum of approximately 30 million shares of common stock. During 2003, approximately 3 million shares were purchased at prices from $4.63 to $10.53 per share. During 2004, approximately 2 million shares were purchased at prices from $18.58 to $21.48 per share. During 2005, approximately 3 million shares were purchased at prices from $18.58 to $29.33 per share. Shares available for future issuance under the Purchase Plan as of December 31, 2005 totaled approximately 15 million shares.

Stock-Based Compensation. The Company measures compensation expense for its stock-based employee compensation plans using the intrinsic value method. The Company recorded compensation expense of approximately $22 million, $32 million and $52 million in 2003, 2004, and 2005, respectively. The recorded

stock compensation expense relates to the amortization of the intrinsic value of Yahoo! stock options issued and assumed in connection with business combinations and other equity-based awards issued by the Company. This expense is generally being amortized using the accelerated amortization method in accordance with FASB Interpretation No. 28 "Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans." As of December 31, 2005, approximately $235 million remains to be amortized over the remaining vesting periods of the options and restricted stock awards when calculated using the intrinsic value method. This amount is not reflective of the future total stock-based compensation expense that will be recorded using the fair value based method for options that will vest in the future. If the fair value based method had been applied in measuring stock compensation expense, the pro forma effect on net income and net income per share would have been as follows (in thousands, except per share amounts):

	Years Ended December 31,		
	2003 [1][2]	2004 [1]	2005 [1]
Net income:			
As reported	$ 237,879	$ 839,553	$1,896,230
Add: Stock compensation expense included in reported net income, net of related tax effects	12,987	19,374	31,557
Less: Stock compensation expense determined under fair value based method for all awards, net of related tax effects	(183,515)	(235,728)	(239,408)
Pro forma net income	$ 67,351	$ 623,199	$1,688,379
Net income per share:			
As reported — basic	$ 0.19	$ 0.62	$ 1.35
As reported — diluted	$ 0.18	$ 0.58	$ 1.28
Pro forma — basic	$ 0.05	$ 0.46	$ 1.21
Pro forma — diluted	$ 0.05	$ 0.43	$ 1.13

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions, including the expected stock price volatility. Because additional stock options are expected to be granted each year, the pro forma disclosures are not representative of pro forma effects on reported financial results for future years. The fair value of option grants is determined using the Black-Scholes option pricing model with the following weighted average assumptions:

	Years Ended December 31,		
	2003	2004	2005
Expected dividend yield	0.0%	0.0%	0.0%
Risk-free interest rate ranges	1.5% - 2.5%	2.2% - 3.1%	3.7% - 4.6%
Expected volatility [1]	62%	50%	35%
Expected life (in years) [2]	3.0	3.5	3.8

[1] Up to September 30, 2005, the Company used an equally weighted average of trailing volatility and market based implied volatility for the computation. Since October 1, 2005 the Company began exclusively using market based implied volatility for the computation.

[2] For the year ended December 31, 2003 the stock compensation expense amounts have been adjusted to reflect lower calculated fair values for employee stock options, which resulted in an increase of $33 million ($0.02 per share) in the pro forma net income. This adjustment was required as the Company's estimate of the fair value of employee stock options was incorrectly based on a five-and-one-half year expected life rather than the three year expected life intended by management.

Note 13 COMMITMENTS AND CONTINGENCIES

Operating Lease Commitments. The Company leases office space and data centers under operating lease agreements with original lease periods up to 23 years which expire between 2006 and 2027.

The Company has entered into the following material lease agreements with minimum lease commitments as of December 31, 2005.

- In 2004, the Company entered into a 23 year lease agreement for office space in Sunnyvale, California with a total expected minimum lease commitment of approximately $149 million over the lease term and a remaining minimum lease commitment of approximately $143 million as of December 31, 2005. The Company has the option to renew the lease for two additional five year terms and the right of first offer to purchase the leased office space if the lessor sells the building.
- In 2005, the Company entered into two ten year lease agreements for data centers in the eastern United States with total expected minimum lease commitments of approximately $280 million over the lease terms and remaining minimum lease commitments of approximately $278 million as of December 31, 2005. The Company has the option to renew each of these leases for an additional five years and also has a right of expansion for any additional lease space that becomes available.
- In 2005, the Company entered into three ten year lease agreement for office space in Southern California with total expected minimum lease commitments of approximately $153 million over the lease terms and remaining minimum lease commitments of approximately $152 million as of December 31, 2005. In each of these leases, the Company has the option to renew for two additional terms of three to five years as well as the right of expansion for any additional lease space that becomes available. Further, in the case of two of these leases, the Company has the right of first offer to purchase the leased office space if the lessor sells the building.

Rent expense for all operating leases was approximately $21 million, $34 million, and $55 million for 2003, 2004, and 2005, respectively.

Many of the Company's leases contain one or more of the following options which the Company can exercise at the end of the initial lease term: (a) renewal of the lease for a defined number of years at the then fair market rental rate or at a slight discount to the fair market rental rate; (b) purchase of the property at the then fair market value; or (c) right of first offer to lease additional space that becomes available.

Net lease commitments as of December 31, 2005 can be summarized as follows (in millions):

Years Ending December 31,	Gross lease commitments	Sublease income	Net lease Commitments
2006	$ 75	$ (4)	$ 71
2007	86	—	86
2008	92	(1)	91
2009	91	—	91
2010	80	—	80
Due after 5 years	414	(1)	413
Total net lease commitments	$838	$ (6)	$832

Other Commitments. In the ordinary course of business, the Company may provide indemnifications of varying scope and terms to customers, vendors, lessors, business partners and other parties with respect to certain matters, including, but not limited to, losses arising out of the Company's breach of such agreements, services to be provided by the Company, or from intellectual property infringement claims made by third parties. In addition, the Company has entered into indemnification agreements with its

directors and certain of its officers that will require the Company, among other things, to indemnify them against certain liabilities that may arise by reason of their status or service as directors or officers. The Company has also agreed to indemnify certain former officers and directors of acquired companies in connection with the acquisition of such companies. The Company maintains director and officer insurance which may cover certain liabilities arising from its obligation to indemnify its directors and officers and former directors and officers of acquired companies, in certain circumstances.

It is not possible to determine the maximum potential amount under these indemnification agreements due to the limited history of prior indemnification claims and the unique facts and circumstances involved in each particular agreement. Such indemnification agreements may not be subject to maximum loss clauses. Historically, the Company has not incurred material costs as a result of obligations under these agreements and it has not accrued any liabilities related to such indemnification obligations in its consolidated financial statements.

On April 21, 2003, Overture completed its purchase of the Web Search unit of Fast Search and Transfer ASA, a Norway based developer of search and real-time filtering technologies, for $70 million in cash, plus a contingent earn-out payment of up to $30 million over three years based on specified operating criteria. The earn-out payment is not included in the contractual obligations table.

Contractual Obligations. The following table presents certain payments due under contractual obligations with minimum firm commitments as of December 31, 2005 (in millions):

	Payments due by period				
	Total	Due in 2006	Due in 2007-2008	Due in 2009-2010	Due in 2011 or after
Long-term debt [1]	$ 750	$ —	$750	$ —	$ —
Operating lease obligations	832	71	177	171	413
Affiliate commitments [2]	211	199	12	—	—
Total contractual obligations	$1,793	$270	$939	$171	$413

[1] The long-term debt matures in April 2008, unless converted into Yahoo! common stock at a conversion price of $20.50 per share, subject to adjustment upon the occurrence of certain events. Upon conversion, the Company has the right to deliver cash in lieu of common stock. See Note 9 — "Long-Term Debt" for additional information related to the long-term debt.

[2] The Company is obligated to make payments under contracts to provide sponsored search services to its affiliates, which represent traffic acquisition costs.

As of December 31, 2004 and 2005, the Company did not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. As such, the Company is not exposed to any financing, liquidity, market, or credit risk that could arise if the Company had engaged in such relationships.

Contingencies. From time to time, third parties assert patent infringement claims against the Company. Currently, the Company is engaged in several lawsuits regarding patent issues and has been notified of a number of other potential patent disputes. In addition, from time to time the Company is subject to other legal proceedings and claims in the ordinary course of business, including claims of alleged infringement of trademarks, copyrights and other intellectual property rights, and a variety of claims, including claims alleging defamation or invasion of privacy, arising in connection with its e-mail, message boards, auction sites, shopping services, and other communications and community features.

On May 24, 2001, Arista Records, Inc., Bad Boy Records, BMG Music d/b/a The RCA Records Label, Capitol Records, Inc., Virgin Records America, Inc., Sony Music Entertainment, Inc., UMG Recordings, Inc., Interscope Records, Motown Record Company, L.P., and Zomba Recording

Corporation filed a lawsuit alleging copyright infringement against LAUNCH in the United States District Court for the Southern District of New York. The plaintiffs allege, among other things, that the consumer-influenced portion of LAUNCH's LAUNCHcast service is "interactive" within the meaning of Section 114 of the Copyright Act and therefore does not qualify for the compulsory license provided for by the Copyright Act. The Complaint seeks declaratory and injunctive relief and damages for the alleged infringement. After the lawsuit was commenced, the Company entered into an agreement to acquire LAUNCH. In June 2001, LAUNCH settled the LAUNCH litigation as to UMG Recordings, Inc. The Company's acquisition of LAUNCH closed in August 2001, and since that time LAUNCH has been a wholly owned subsidiary of the Company. The Company and LAUNCH do not believe that LAUNCH has infringed any rights of plaintiffs and intend to vigorously contest the lawsuit. In January 2003, LAUNCH settled the LAUNCH litigation as to Sony Music Entertainment, Inc. In October 2003, LAUNCH settled the litigation as to Capitol Records, Inc. and Virgin Records America, Inc. Accordingly, BMG Music d/b/a/ The RCA Records Label is the sole remaining plaintiff in this proceeding. On March 16, 2004 the plaintiff filed motions for partial summary judgment on the issues of willful infringement and whether the consumer-influenced portion of LAUNCH's LAUNCHcast service is "interactive" within the meaning of Section 114 of the Copyright Act and therefore does not qualify for the compulsory license provided for by the Copyright Act. LAUNCH filed its opposition to the motions for partial summary judgment on April 30, 2004, and a hearing on the motions was held on June 18, 2004. On November 4, 2005, the Court issued an order denying the plaintiff's summary judgment motions as to infringement and willful infringement. A trial date is currently set for June 2006. The Company does not believe it is feasible to predict or determine the outcome or resolution of the remaining LAUNCH litigation at this time. The range of possible resolutions of such LAUNCH litigation could include judgments against LAUNCH or settlements that could require substantial payments by LAUNCH.

On July 12, 2001, the first of several purported securities class action lawsuits was filed in the United States District Court for the Southern District of New York against certain underwriters involved in Overture's initial public offering, Overture, and certain of Overture's current and former officers and directors. The Court consolidated the cases against Overture. Plaintiffs allege, among other things, violations of the Securities Act of 1933 and the Securities Exchange Act of 1934 involving undisclosed compensation to the underwriters, and improper practices by the underwriters, and seek unspecified damages. Similar complaints were filed in the same court against numerous public companies that conducted initial public offerings of their common stock since the mid-1990s. All of these lawsuits were consolidated for pretrial purposes before Judge Shira Scheindlin. On April 19, 2002, plaintiffs filed an amended complaint, alleging Rule 10b-5 claims of fraud. On July 15, 2002, the issuers filed a motion to dismiss for failure to comply with applicable pleading standards. On October 8, 2002, the Court entered an Order of Dismissal as to all of the individual defendants in the Overture IPO litigation, without prejudice. On February 19, 2003, the Court denied the motion to dismiss the Rule 10b-5 claims against certain defendants, including Overture. On August 31, 2005, the Court entered an order confirming its preliminary approval of a settlement proposal made by plaintiffs, which includes settlement of, and release of claims against, the issuer defendants, including Overture. A hearing on the fairness of the settlement to the shareholder class is currently set for April 24, 2006. If the settlement does not occur, and litigation against Overture continues, the Company and Overture believe that Overture has meritorious defenses to liability and damages and will continue to defend the case vigorously.

The Company does not believe, based on current knowledge, that any of the foregoing legal proceedings or claims are likely to have a material adverse effect on its financial position, results of operations or cash flows. However, the Company may incur substantial expenses in defending against third party claims. In the event of a determination adverse to the Company or its subsidiaries, the Company may incur substantial monetary liability, and be required to change its business practices. Either of these could have a material adverse effect on the Company's financial position, results of operations or cash flows.

Note 14 LITIGATION SETTLEMENT

In April 2002, the Company's wholly owned subsidiary, Overture, filed a lawsuit against Google Inc. ("Google") in the United States District Court for the Northern District of California with respect to a patent which protected various features and innovations relating to bid-for-performance products and Overture's pay-for-performance (sponsored) search technologies. In addition, the Company had a second dispute with Google concerning the shares issuable to the Company pursuant to a warrant held by the Company to purchase Google shares that were received in connection with a June 2000 services agreement.

In August 2004, Google issued 2.7 million shares of Class A common stock in settlement of the two disputes. The Company agreed to dismiss the 361 patent lawsuits and granted to Google a fully-paid license to the 361 patent as well as several related patent applications held by Overture. The Company allocated the 2.7 million shares between the two disputes, based on the relative fair values of the two disputes, including consideration of a valuation performed by a third party. A portion of the shares allocated to the patent dispute has been recorded as an adjustment to goodwill for the period that the patents were in effect prior to Overture's acquisition by the Company. The portion of the shares received for the settlement of the patent dispute which has been allocated to future periods has been recorded in deferred revenue on the consolidated balance sheets and will be recognized as fees revenues over the remaining life of the patent, approximately 12 years. The shares allocated to the warrant dispute settlement did not have an income statement effect as the fair value of the warrant was recorded at the time the services were performed based on the fair value of the services rendered.

During the year ended December 31, 2004, the Company disposed of approximately 4.0 million shares of Google and realized gains of $413 million, net of selling costs, which were included in other income, net on the consolidated statements of operations. During the year ended December 31, 2005 the Company sold the remaining Google shares and realized gains of $961 million, which were recorded in other income, net.

Note 15 SEGMENTS

The Company manages its business geographically. The primary areas of measurement and decision-making are the United States and International. Management relies on an internal management reporting process that provides revenue and segment operating income before depreciation and amortization for making financial decisions and allocating resources. Segment operating income before depreciation and amortization includes income from operations before depreciation, amortization of intangible assets and amortization of stock compensation expense. Management believes that segment operating income before depreciation and amortization is an appropriate measure for evaluating the operational performance of the Company's segments. However, this measure should be considered in addition to, not as a substitute for, or superior to, income from operations or other measures of financial performance prepared in accordance with generally accepted accounting principles.

The following tables present summarized information by segment (in thousands):

	Years Ended December 31,		
	2003	2004	2005
Revenues by segment:			
United States	$ 1,355,153	$ 2,653,437	$ 3,667,509
International	269,944	921,080	1,590,159
Total revenues	$ 1,625,097	$ 3,574,517	$ 5,257,668
Segment operating income before depreciation and amortization:			
United States	$ 441,372	$ 891,103	$ 1,219,539
International	36,011	140,809	337,799
Total segment operating income before depreciation and amortization	477,383	1,031,912	1,557,338
Corporate and unallocated operating costs and expenses:			
Depreciation and amortization	(159,688)	(311,041)	(397,142)
Stock compensation expense	(22,029)	(32,290)	(52,471)
Income from operations	$ 295,666	$ 688,581	$ 1,107,725
Capital expenditures, net:			
United States	$ 94,305	$ 190,461	$ 336,450
International	23,024	55,040	72,484
Total capital expenditures, net	$ 117,329	$ 245,501	$ 408,934

	December 31,	
	2004	2005
Property and equipment, net:		
United States	$ 461,623	$ 613,426
International	70,073	84,096
Total property and equipment, net	$ 531,696	$ 697,522

Revenue is attributed to individual countries according to the international online property that generated the revenue. No single foreign country accounted for more than 10 percent of revenues in 2003, 2004, and 2005.

The following table presents revenues for groups of similar services (in thousands):

	Years Ended December 31,		
	2003	2004	2005
Marketing services [1]	$1,321,938	$3,127,229	$4,593,972
Fees	303,159	447,288	663,696
Total revenues	$1,625,097	$3,574,517	$5,257,668

[1] The Company reclassified previously reported marketing services revenue of $5 million and $22 million, respectively, as fees revenue for the years ended December 31, 2003 and 2004 in order to refine the alignment of revenue sources with these classifications.

Revenues from the Company's agreements with Overture were included in marketing services for the period from January 1, 2003 through October 7, 2003. Revenues from Overture for the period from January 1, 2003 through October 7, 2003, amounted to 12 percent of total revenues for the year ended December 31, 2003.

Note 16 Related Party Transactions

The Company and other third parties are limited partners in Softbank Capital Partners LP ("Softbank Capital"), a venture capital fund which is an affiliate of SOFTBANK. A Managing Partner of Softbank Capital is also a member of the Company's Board of Directors. The total investment by the Company in Softbank Capital is approximately $36 million and represents less than a 5 percent holding in Softbank Capital. A significant portion of this investment has been impaired by the Company, with the remaining value included on the consolidated balance sheets in other assets. Pursuant to the Partnership Agreement, the Company invested on the same terms and on the same basis as all other limited partners.

Revenue from related parties, excluding Yahoo! Japan, represented no more than 1 percent of the total revenue in the years ended December 31, 2003, 2004, and 2005. Management believes that prices on agreements with related parties were comparable to those with other similarly situated customers of the Company.

See Note 4 — "Investments in Equity Interests" for additional information related to transactions involving Yahoo! Japan.

Note 17 Subsequent Events

Joint Venture with Seven Networks Limited. On January 29, 2006, the Company and Seven Network Limited ("Seven"), a leading Australian media company, completed a strategic partnership in which the Company contributed its Australian Internet business, Yahoo! Australia and New Zealand, and Seven contributed its online assets, television and magazine content, an option to purchase its 33 percent ownership interest in mobile solutions provider m.Net Corporation Ltd, and cash of AUD $10 million (approximately $7 million). The Company has a 50 percent equity ownership interest in the newly formed entity, which will operate as "Yahoo!7." Pursuant to a shareholders agreement and a power of attorney granted by Seven to vote certain of its shares, the Company has the right to vote 50.1 percent of the outstanding voting interests in Yahoo!7 and control over the day-to-day operations and will therefore consolidate Yahoo!7's results.

Structured Stock Repurchase. Subsequent to December 31, 2005, the Company received $272 million in cash from the settlement of a structured stock repurchase transaction of $250 million entered into in July 2005 and 3 million shares at an average price of $36.60 per share from a $110 million transaction entered into in November 2005. Additionally, subsequent to December 31, 2005, the Company entered into $250 million in structured stock repurchase transactions in tranches of $50 million and $200 million which will mature in July 2006. On the maturity dates if the market price of Yahoo! common stock is at or above $34.50 for the $200 million tranche and $33.90 for the $50 million tranche, the Company will have its investment returned with a premium, otherwise the Company will repurchase up to an aggregate of 8 million shares.

Stock Repurchase Transactions. Subsequent to December 31, 2005, the Company repurchased 19 million shares of its common stock under the current stock repurchase program at an average price of $33.51 per share, for a total amount of $639 million.

Schedule II — Valuation and Qualifying Accounts

Years Ended December 31, 2003, 2004, and 2005
(in thousands)

	Balance at Beginning of Year	Charged to Expenses	Write-Offs Net of Recoveries	Balance at End of Year
Accounts receivable				
Allowance for doubtful accounts				
2003	$ 23,852	$ 10,625	$ (2,516)	$ 31,961
2004	31,961	11,487	(9,233)	34,215
2005	34,215	14,692	(7,050)	41,857

	Balance at Beginning of Year	Charged (Credited) to Expenses	Charged (Credited) to Other Accounts [1]	Balance at End of Year
Deferred income tax asset				
Valuation allowance				
2003	$1,560,075	$ 8,516	$ 90,960	$1,659,551
2004	1,659,551	(40,612)	(265,191)	1,353,748
2005	1,353,748	16,342	137,758	1,507,848

[1] Amounts not charged (credited) to expenses were charged (credited) to equity or goodwill.

Selected Quarterly Financial Data

(unaudited) (in thousands, except per share amounts)

	Quarters Ended							
	March 31, 2004	June 30, 2004	September 30, 2004	December 31, 2004	March 31, 2005	June 30, 2005	September 30, 2005	December 31, 2005
Revenues	$ 757,786	$ 832,299	$ 906,715	$1,077,717	$1,173,742	$1,252,997	$1,329,929	$1,501,000
Gross profit	$ 466,825	$ 524,974	$ 563,789	$ 676,591	$ 706,818	$ 752,839	$ 795,548	$ 906,262
Net income [1]	$ 101,212	$ 112,512	$ 253,305	$ 372,524	$ 204,560	$ 754,689	$ 253,773	$ 683,208
Net income per share — basic [1]	$ 0.08	$ 0.08	$ 0.19	$ 0.27	$ 0.15	$ 0.54	$ 0.18	$ 0.48
Net income per share — diluted [1]	$ 0.07	$ 0.08	$ 0.17	$ 0.25	$ 0.14	$ 0.51	$ 0.17	$ 0.46
Shares used in per share calculation — basic	1,328,154	1,347,459	1,361,136	1,377,007	1,384,958	1,395,596	1,405,012	1,416,118
Shares used in per share calculation — diluted	1,426,548	1,449,707	1,458,610	1,475,131	1,477,811	1,484,200	1,486,876	1,496,942

(1) The net income includes gains, net of tax, for the quarters ended September 30, 2004, December 31, 2004 and June 30, 2005 of $129 million, or $0.09 per basic and diluted share, $185 million or $0.13 per basic and diluted share net of tax, $573 million or $0.41 per basic and $0.39 per diluted share, respectively related to sales of an investment. The net income for the quarter ended December 31, 2005 includes a gain, net of tax, of $205 million or $0.15 per basic share and $0.14 per diluted share with respect to the divestiture of Yahoo! China and a tax benefit of $248 million or $0.18 per basic share and $0.17 per diluted share with respect to a subsidiary restructuring transaction. The quarterly tax impact on the gains has been calculated using the annual effective tax rate determined at the end of the respective years.

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

None.

Item 9A. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

The Company's management, with the participation of the Company's principal executive officer and principal financial officer, has evaluated the effectiveness of the Company's disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act") as of the end of the period covered by this report. Based on such evaluation, the Company's principal executive officer and principal financial officer have concluded that, as of the end of such period, the Company's disclosure controls and procedures are effective in recording, processing, summarizing and reporting, on a timely basis, information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act.

Management's Report on Internal Control Over Financial Reporting

The Company's management is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act. Under the supervision and with the participation of the Company's management, including its principal executive officer and principal financial officer, the Company conducted an evaluation of the effectiveness of its internal control over financial reporting based on criteria established in the framework in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this evaluation, the Company's management concluded that its internal control over financial reporting was effective as of December 31, 2005.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risks that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

The Company's independent registered public accounting firm has audited management's assessment of the effectiveness of the Company's internal control over financial reporting as of December 31, 2005 as stated in their report which appears on page 57.

Changes in Internal Control Over Financial Reporting

There have not been any changes in the Company's internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

Item 9B. Other Information

None.

Part III

Item 10. Directors and Executive Officers of the Registrant

The information required by this item is incorporated by reference to Yahoo!'s Proxy Statement for its 2006 Annual Meeting of Stockholders to be filed with the SEC within 120 days after the end of the fiscal year ended December 31, 2005.

Item 11. Executive Compensation

The information required by this item is incorporated by reference to Yahoo!'s Proxy Statement for its 2006 Annual Meeting of Stockholders to be filed with the SEC within 120 days after the end of the fiscal year ended December 31, 2005.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

The information required by this item is incorporated by reference to Yahoo!'s Proxy Statement for its 2006 Annual Meeting of Stockholders to be filed with the SEC within 120 days after the end of the fiscal year ended December 31, 2005.

Item 13. Certain Relationships and Related Transactions

The information required by this item is incorporated by reference to Yahoo!'s Proxy Statement for its 2006 Annual Meeting of Stockholders to be filed with the SEC within 120 days after the end of the fiscal year ended December 31, 2005.

Item 14. Principal Accounting Fees and Services

The information required by this item is incorporated by reference to Yahoo!'s Proxy Statement for its 2006 Annual Meeting of Stockholders to be filed with the SEC within 120 days after the end of the fiscal year ended December 31, 2005.

Part IV

Item 15. Exhibits and Financial Statement Schedules

(b) Exhibits are incorporated herein by reference or are filed with this report as indicated below (numbered in accordance with Item 601 of Regulation S-K):

Exhibit Number	Description
2.1	Stock Purchase and Contribution Agreement, dated as of August 10, 2005, by and between Yahoo! Inc. and Alibaba.com Corporation (filed as Exhibit 2.1 to the Registrant's Current Report on Form 8-K, filed August 16, 2005 and incorporated herein by reference.)
2.2	Amendment to the Stock Purchase and Contribution Agreement, dated as of October 24, 2005, by and between Yahoo! Inc. and Alibaba.com Corporation (filed as Exhibit 2.2 to the Registrant's Current Report on Form 8-K, filed October 27, 2005 [the October 27, 2005 Form 8-K] and incorporated herein by reference.)
2.3	Tao Bao Share Purchase Agreement, dated as of October 24, 2005, by and among Yahoo! Inc., SOFTBANK CORP. and SB TB Holding Limited (filed as Exhibit 2.3 to the October 27, 2005 Form 8-K and incorporated herein by reference.)
2.4	Secondary Share Purchase Agreement, dated as of October 24, 2005, by and among Yahoo! Inc. and certain shareholders of Alibaba.com Corporation (filed as Exhibit 2.4 to the October 27, 2005 Form 8-K and incorporated herein by reference.)
2.5	Shareholders Agreement, dated as of October 24, 2005, by and among Alibaba.com Corporation, Yahoo! Inc., SOFTBANK CORP., the Management Members, and the other shareholders named therein (filed as Exhibit 2.5 to the October 27, 2005 Form 8-K and incorporated herein by reference.)
3.1	Amended and Restated Certificate of Incorporation of Registrant (Filed as Exhibit 3.1 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2000 and incorporated herein by reference.)
3.2	Amended Bylaws of Registrant (Filed as Exhibit 4.9 to the Registrant's Registration Statement on Form S-8 filed on March 5, 2002 [the March 5, 2002 Form S-8] and incorporated herein by reference.)
4.1	Form of Senior Indenture (Filed as Exhibit 4.1 to the Registrant's Registration Statement on Form S-3, Registration No. 333-46458, filed September 22, 2000 [the September 22, 2000 Form S-3] and incorporated herein by reference.)
4.2	Form of Subordinated Indenture (Filed as Exhibit 4.2 to the September 22, 2000 Form S-3 and incorporated herein by reference.)
4.3**	Form of Senior Note
4.4**	Form of Subordinated Note
4.5**	Form of Certificate of Designation for Preferred Stock (together with Preferred Stock certificate.)
4.6	Form of Deposit Agreement (together with Depository Receipt) (Filed as Exhibit 4.6 to the September 22, 2000 Form S-3 and incorporated herein by reference.)
4.7**	Form of Warrant Agreement (together with Form of Warrant Certificate.)
4.8	Amended and Restated Rights Agreement, dated as of April 1, 2005, by and between Yahoo! Inc. and Equiserve Trust Company, N.A., as rights agent (Filed as Exhibit 4.1 to the Registrant's Current Report on Form 8-K, filed April 4, 2005, and incorporated herein by reference.)

4.9 Indenture, dated as of April 9, 2003 by and between the Registrant and U. S. Bank National Association (Filed as Exhibit 4.1 to the Registrant's Current Report on Form 8-K filed on April 10, 2003 [the April 10, 2003 Form 8-K] and incorporated herein by reference.)

4.10 Registration Rights Agreement, dated as of April 9, 2003 among the Registrant and Credit Suisse First Boston LLC (Filed as Exhibit 4.2 to the April 10, 2003 Form 8-K and incorporated herein by reference.)

10.1+ Form of Indemnification Agreement with certain of the Registrant's officers and directors (Filed as Exhibit 10.1 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 1999 and incorporated herein by reference.)

10.2+ Yahoo! Inc. Amended and Restated 1995 Stock Plan (Filed as Annex A to the Registrant's definitive proxy statement filed on April 4, 2005 [the 2005 Proxy Statement] and incorporated herein by reference), Form of Stock Option Agreement thereunder (Filed as Exhibit 10.2 to the Registrant's Current Report on Form 8-K, filed May 25, 2005 [the May 25, 2005 Form 8-K] and incorporated herein by reference), Form of Restricted Stock Award Agreement thereunder (Filed as Exhibit 10.3 to the May 25, 2005 Form 8-K and incorporated herein by reference) and Form of Restricted Stock Unit Award Agreement thereunder (Filed as Exhibit 10.33) to the Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2005 and incorporated herein by reference.)

10.3+ Form of Management Continuity Agreement with certain of the Registrant's Executive Officers (Filed as Exhibit 10.3 to the Registrant's Registration Statement on Form SB-2, Registration No. 333-2142-LA, declared effective on April 11, 1996 [the SB-2 Registration Statement] and incorporated herein by reference.)

10.4*+ Amended and Restated 1996 Employee Stock Purchase Plan and Form of subscription agreement.

10.5 Yahoo! Inc. Amended and Restated 1996 Directors' Stock Option Plan, as amended (Filed as Annex B to the 2005 Proxy Statement and incorporated herein by reference) and Form of option agreement thereunder (Filed as Exhibit 10.21 to the SB-2 Registration Statement and incorporated herein by reference.)

10.6 Joint Venture Agreement dated April 1, 1996 by and between the Registrant and SOFTBANK Corporation (Filed as Exhibit 10.7 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2002 and incorporated herein by reference.)

10.7 Yahoo! Japan License Agreement dated April 1, 1996 by and between the Registrant and Yahoo! Japan Corporation (Filed as Exhibit 10.43 to Amendment No. 2 to the Registrant's Registration Statement on Form S-3 filed on December 23, 2002 [the December 23, 2002 Form S-3] and incorporated herein by reference.)

10.8 Amendment Agreement dated September 17, 1997 by and between Registrant and SOFTBANK Corporation (Filed as Exhibit 10.11 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2002 and incorporated herein by reference.)

10.9 Amendment to Yahoo! Japan License Agreement dated September 17, 1997 by and between the Registrant and Yahoo! Japan Corporation (Filed as Exhibit 10.40 to the November 27, 2002 Form S-3 and incorporated herein by reference.)

10.10+ Employment Letter, dated as of March 19, 2001, between the Registrant and Gregory Coleman (Filed as Exhibit 10.36 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended March 31, 2001 and incorporated herein by reference.)

10.11+ Employment Letter, dated as of April 16, 2001, between the Registrant and Terry S. Semel (Filed as Exhibit 10.39 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2001 [the June 30, 2001 10-Q] and incorporated herein by reference.)

10.12+	Stock Purchase Agreement, dated as of April 16, 2001, between the Registrant and Terry S. Semel (Filed as Exhibit 10.40 to the June 30, 2001 10-Q and incorporated herein by reference.)
10.13	Consent and Resale Agreement dated as of March 25, 2002, between the Registrant and SOFTBANK Corp. (Filed as Exhibit 10.40 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended March 31, 2002 and incorporated herein by reference.)
10.14+	Employment agreement between Registrant and Daniel Rosensweig dated April 23, 2002 (Filed as Exhibit 10.41 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2002 [the June 30, 2002 10-Q] and incorporated herein by reference.)
10.15+	Recourse Promissory Note executed by Daniel Rosensweig for the benefit of Registrant (Filed as Exhibit 10.42 to the June 30, 2002 10-Q and incorporated herein by reference.)
10.16+	Yahoo! Key Executive New Hire Retention Plan (Filed as Exhibit 10.43 to the June 30, 2002 10-Q and incorporated herein by reference.)
10.17+	Key Executive New Hire Retention Agreement between the Registrant and Daniel Rosensweig (Filed as Exhibit 10.44 to the June 30, 2002 10-Q and incorporated herein by reference.)
10.18+	Employment Letter, dated as of March 20, 2003 between the Registrant and Gregory Coleman (Filed as Exhibit 10.36 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended March 31, 2003 and incorporated herein by reference.)
10.19	Waiver and Voting Agreement between the Registrant and SOFTBANK Corp. dated February 26, 2004 (Filed as Exhibit 10.38 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended March 31, 2004 and incorporated herein by reference.)
10.20+	Employment Letter, dated October 29, 2004, between the Registrant and Michael Murray (Filed as Exhibit 10.29 to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2004 [the December 31, 2004 10-K] and incorporated herein by reference.)
10.21	Amendment No. 2 to Yahoo! Japan License Agreement dated January 31, 2005 by and between the Registrant and Yahoo! Japan Corporation (Filed as Exhibit 10.30 to the December 31, 2004 10-K and incorporated herein by reference.)
10.22*+	Summary of Compensation Payable to Named Executive Officers
21.1*	List of Subsidiaries
23.1*	Consent of Independent Registered Public Accounting Firm
24.1	Power of Attorney (see the signature page of this Annual Report on Form 10-K.)
31.1*	Certificate of Chief Executive Officer Pursuant to Securities Exchange Act Rules 13a-14(a) and 15d-14(a) as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, dated March 3, 2006.
31.2*	Certificate of Chief Financial Officer Pursuant to Securities Exchange Act Rules 13a-14(a) and 15d-14(a) as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, dated March 3, 2006.
32*	Certificate of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, dated March 3, 2006.

* Filed herewith.

** To be filed by a report on Form 8-K pursuant to Item 601 of Regulation S-K or, where applicable, incorporated herein by reference from a subsequent filing in accordance with Section 305(b)(2) of the Trust Indenture Act of 1939.

\+ Indicates a management contract or compensatory plan or arrangement.

Signatures

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused the report to be signed on its behalf by the undersigned, thereunto duly authorized, on the 3rd day of March 2006.

YAHOO! INC.

By: /s/ SUSAN DECKER
Susan Decker
Executive Vice President, Finance and Administration and Chief Financial Officer

Power of Attorney

KNOW ALL PERSONS BY THESE PRESENTS, that each person whose signature appears below constitutes and appoints Terry Semel and Susan Decker, his/her attorneys-in-fact, each with the power of substitution, for him/her in any and all capacities, to sign any amendments to this Report on Form 10-K and to file the same, with Exhibits thereto and other documents in connection therewith with the Securities and Exchange Commission, hereby ratifying and confirming all that each of said attorneys-in-fact, or substitute or substitutes may do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated:

Signature	Title	Date
/s/ TERRY SEMEL Terry Semel	Chairman and Chief Executive Officer (Principal Executive Officer)	March 3, 2006
/s/ SUSAN DECKER Susan Decker	Executive Vice President, Finance and Administration and Chief Financial Officer (Principal Financial Officer)	March 3, 2006
/s/ MICHAEL MURRAY Michael Murray	Senior Vice President, Finance and Chief Accounting Officer (Principal Accounting Officer)	March 3, 2006
/s/ ROY BOSTOCK Roy Bostock	Director	March 3, 2006
/s/ RONALD BURKLE Ronald Burkle	Director	March 3, 2006
/s/ ERIC HIPPEAU Eric Hippeau	Director	March 3, 2006
/s/ VYOMESH JOSHI Vyomesh Joshi	Director	March 3, 2006
/s/ ARTHUR KERN Arthur Kern	Director	March 3, 2006

Signature	Title	Date
/s/ ROBERT KOTICK Robert Kotick	Director	March 3, 2006
/s/ EDWARD KOZEL Edward Kozel	Director	March 3, 2006
/s/ GARY WILSON Gary Wilson	Director	March 3, 2006
/s/ JERRY YANG Jerry Yang	Director	March 3, 2006

EXHIBIT 31.1

Certification of Chief Executive Officer Pursuant to Securities Exchange Act Rules 13a-14(a) and 15d-14(a) as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

I, Terry Semel, the Chief Executive Officer of Yahoo! Inc., certify that:

1. I have reviewed this annual report on Form 10-K of Yahoo! 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 annual 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 annual 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 (the registrant's fourth quarter in the case of an annual report) 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 (or persons performing the equivalent functions):

   (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.

Dated: March 3, 2006

By: /s/ TERRY SEMEL
Terry Semel
Chief Executive Officer

EXHIBIT 31.2

Certification of Chief Financial Officer Pursuant to Securities Exchange Act Rules 13a-14(a) and 15d-14(a) as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

I, Susan Decker, the Chief Financial Officer of Yahoo! Inc., certify that:

1. I have reviewed this annual report on Form 10-K of Yahoo! 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 annual 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 annual 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 (the registrant's fourth quarter in the case of an annual report) 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 (or persons performing the equivalent functions):

   (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.

Dated: March 3, 2006

By: /s/ SUSAN DECKER
Susan Decker
Chief Financial Officer

EXHIBIT 32

Certification of Chief Executive Officer and Chief Financial Officer 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 Annual Report on Form 10-K of Yahoo! (the "Company") for the year ended December 31, 2005 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), Terry Semel, as Chief Executive Officer of the Company, and Susan Decker, as Chief Financial Officer of the Company, each hereby certifies, pursuant to 18 U.S.C. §1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, to the best of his and her knowledge, respectively, 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/ TERRY SEMEL
Name: Terry Semel
Title: Chief Executive Officer
Dated: March 3, 2006

/s/ SUSAN DECKER
Name: Susan Decker
Title: Chief Financial Officer
Dated: March 3, 2006

The foregoing certification is being furnished pursuant to 18 U.S.C. Section 1350. It is not being filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and it is not to be incorporated by reference into any filing of the Company, regardless of any general incorporation language in such filing.

EXHIBIT CO 0731

10kWIZARD
SEC POWER SEARCH

FORM 10-Q

APPLE COMPUTER INC - AAPL

Filed: May 05, 2006 (period: April 01, 2006)

Quarterly report which provides a continuing view of a company's financial position

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SIGNATURE

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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 April 1, 2006

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: 000-10030

APPLE COMPUTER, INC.
(Exact name of registrant as specified in its charter)

CALIFORNIA (State or other jurisdiction of incorporation or organization)	942404110 (I.R.S. Employer Identification No.)
1 Infinite Loop Cupertino, California (Address of principal executive offices)	95014 (Zip Code)

Registrant's telephone number, including area code: (408) 996-1010

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 ☐

Source: APPLE COMPUTER INC, 10-Q, May 05, 2006

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b–2 of the Exchange Act).

Yes ☐ No ☒

850,508,144 shares of common stock issued and outstanding as of April 26, 2006

Source: APPLE COMPUTER INC, 10-Q, May 05, 2006

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

APPLE COMPUTER, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (Unaudited)
(in millions, except share and per share amounts)

	Three Months Ended		Six Months Ended	
	April 1, 2006	March 26, 2005	April 1, 2006	March 26, 2005
Net sales	$ 4,359	$ 3,243	$ 10,108	$ 6,733
Cost of sales (1)	3,062	2,275	7,247	4,769
Gross margin	1,297	968	2,861	1,964
Operating expenses:				
Research and development (1)	176	119	358	242
Selling, general, and administrative (1)	592	447	1,224	917
Total operating expenses	768	566	1,582	1,159
Operating income	529	402	1,279	805
Other income and expense	76	33	157	59
Income before provision for income taxes	605	435	1,436	864
Provision for income taxes	195	145	461	279
Net income	$ 410	$ 290	$ 975	$ 585
Earnings per common share:				
Basic	$ 0.49	$ 0.36	$ 1.17	$ 0.73
Diluted	$ 0.47	$ 0.34	$ 1.11	$ 0.69
Shares used in computing earnings per share (in thousands):				
Basic	840,910	808,172	835,658	798,602
Diluted	878,537	857,011	875,725	848,553

	Three Months Ended		Six Months Ended	
	April 1, 2006	March 26, 2005	April 1, 2006	March 26, 2005
(1) Stock-based compensation expense was allocated as follows:				
Cost of sales	$ 5	$ 1	$ 10	$ 1
Research and development	$ 13	$ 1	$ 28	$ 3
Selling, general, and administrative	$ 24	$ 8	$ 48	$ 16

See accompanying notes to condensed consolidated financial statements.

Source: APPLE COMPUTER INC, 10-Q, May 05, 2006

APPLE COMPUTER, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS (Unaudited)
(in millions, except share amounts)

	April 1, 2006	September 24, 2005
ASSETS:		
Current assets:		
Cash and cash equivalents	$ 6,346	$ 3,491
Short-term investments	1,880	4,770
Accounts receivable, less allowances of $48 and $46, respectively	861	895
Inventories	204	165
Deferred tax assets	459	331
Other current assets	1,536	648
Total current assets	11,286	10,300
Property, plant and equipment, net	1,005	817
Goodwill	69	69
Acquired intangible assets, net	41	27
Other assets	1,510	338
Total assets	$ 13,911	$ 11,551
LIABILITIES AND SHAREHOLDERS' EQUITY:		
Current liabilities:		
Accounts payable	$ 2,108	$ 1,779
Accrued expenses	2,348	1,705
Total current liabilities	4,456	3,484
Non-current liabilities	773	601
Total liabilities	5,229	4,085
Commitments and contingencies		
Shareholders' equity:		
Common stock, no par value; 1,800,000,000 shares authorized; 849,188,157 and 835,019,364 shares issued and outstanding, respectively	4,014	3,521
Deferred stock compensation	—	(60)
Retained earnings	4,673	4,005
Accumulated other comprehensive income (loss)	(5)	—
Total shareholders' equity	8,682	7,466
Total liabilities and shareholders' equity	$ 13,911	$ 11,551

See accompanying notes to condensed consolidated financial statements.

Source: APPLE COMPUTER INC, 10-Q, May 05, 2006

APPLE COMPUTER, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)
(in millions)

	Six Months Ended	
	April 1, 2006	March 26, 2005
Cash and cash equivalents, beginning of the period	$ 3,491	$ 2,969
Operating Activities:		
Net income	975	585
Adjustments to reconcile net income to cash generated by operating activities:		
Depreciation, amortization, and accretion	102	82
Stock-based compensation expense	86	20
Provision for deferred income taxes	83	13
Excess tax benefits from stock options	—	275
Loss on disposition of property, plant, and equipment	3	4
Changes in operating assets and liabilities:		
Accounts receivable	34	(114)
Inventories	(39)	(63)
Other current assets	(892)	(116)
Other assets	(1,195)	(56)
Accounts payable	329	322
Other liabilities	672	359
Cash generated by operating activities	158	1,311
Investing Activities:		
Purchases of short-term investments	(3,792)	(5,304)
Proceeds from maturities of short-term investments	6,683	2,750
Proceeds from sales of short-term investments	—	242
Purchases of property, plant, and equipment	(275)	(101)
Other	(61)	(19)
Cash generated by (used for) investing activities	2,555	(2,432)
Financing Activities:		
Proceeds from issuance of common stock	212	406
Excess tax benefits from stock-based compensation	283	—
Repurchases of common stock	(353)	—
Cash generated by financing activities	142	406
Increase (decrease) in cash and cash equivalents	2,855	(715)
Cash and cash equivalents, end of the period	$ 6,346	$ 2,254
Supplemental cash flow disclosure:		
Cash paid for income taxes, net	$ 84	$ 47

See accompanying notes to condensed consolidated financial statements.

Source: APPLE COMPUTER INC, 10-Q, May 05, 2006

Note 1 – Summary of Significant Accounting Policies

Apple Computer, Inc. and its subsidiaries (the Company) designs, manufactures, and markets personal computers and related software, services, peripherals, and networking solutions. The Company also designs, develops, and markets a line of portable digital music players along with related accessories and services including the online distribution of third–party music, audio books, music videos, short films, and television shows. The Company sells its products worldwide through its online stores, its own retail stores, its direct sales force, and third–party wholesalers, resellers, and value–added resellers. In addition to its own hardware, software, and peripheral products, the Company sells a variety of third–party hardware and software products through its online and retail stores. The Company sells to education, consumer, creative professional, business, and government customers.

Basis of Presentation and Preparation
The accompanying condensed consolidated financial statements include the accounts of the Company. Intercompany accounts and transactions have been eliminated. The preparation of these condensed consolidated financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in these condensed consolidated financial statements and accompanying notes. Actual results could differ materially from those estimates. Certain prior year amounts in the consolidated financial statements and notes thereto have been reclassified to conform to the current year presentation.

These condensed consolidated financial statements and accompanying notes should be read in conjunction with the Company's annual consolidated financial statements and the notes thereto for the fiscal year ended September 24, 2005, included in its Annual Report on Form 10–K (the 2005 Form 10–K).

The Company's fiscal year is the 52 or 53–week period that ends on the last Saturday of September. The Company's first quarter of fiscal year 2006 contained 14 weeks and the first quarter of its fiscal year 2005 contained 13 weeks. The Company's fiscal year 2006 will end on September 30, 2006 and include 53 weeks while fiscal year 2005 included 52 weeks. Unless otherwise stated, references to particular years or quarters refer to the Company's fiscal years ended in September and the associated quarters of those fiscal years.

Software Development Costs
Research and development costs are expensed as incurred. Development costs of computer software to be sold, leased, or otherwise marketed are subject to capitalization beginning when a product's technological feasibility has been established and ending when a product is available for general release to customers pursuant to Statement of Financial Accounting Standards (SFAS) No. 86, *Computer Software to be Sold, Leased, or Otherwise Marketed.* In most instances, the Company's products are released soon after technological feasibility has been established. Therefore, costs incurred subsequent to achievement of technological feasibility are usually not significant, and generally all software development costs have been expensed.

In the fourth quarter of 2004, the Company began incurring substantial development costs associated with Mac OS X version 10.4 Tiger subsequent to achievement of technological feasibility as evidenced by public demonstration in August 2004 and the subsequent release of a developer beta version of the product. During the first and second quarters of 2005, the Company capitalized approximately $14.8 million and $14.7 million, respectively, of costs associated with the development of Tiger. In accordance with SFAS No. 86, amortization of this asset to cost of sales began in April 2005 when the Company began shipping Tiger and is being recognized on a straight–line basis over a three–year estimated useful life.

Stock–Based Compensation
On September 25, 2005, the Company adopted SFAS No. 123 (revised 2004) (SFAS No. 123R), *Share–Based Payment*, which addresses the accounting for stock–based payment transactions in which an enterprise receives employee services in exchange for (a) equity instruments of the enterprise or (b) liabilities that are based on the fair value of the enterprise's equity instruments or that may be settled by the issuance of such equity instruments. In January 2005, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin (SAB) No. 107,

Source: APPLE COMPUTER INC, 10-Q, May 05, 2006

which provides supplemental implementation guidance for SFAS No. 123R. SFAS No. 123R eliminates the ability to account for stock-based compensation transactions using the intrinsic value method under Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*, and instead generally requires that such transactions be accounted for using a fair-value-based method. The Company uses the Black-Scholes-Merton ("BSM") option-pricing model to determine the fair-value of stock-based awards under SFAS No. 123R, consistent with that used for pro forma disclosures under SFAS No. 123, *Accounting for Stock-Based Compensation*. The Company has elected the modified prospective transition method as permitted by SFAS No. 123R and accordingly prior periods have not been restated to reflect the impact of SFAS No. 123R. The modified prospective transition method requires that stock-based compensation expense be recorded for all new and unvested stock options, restricted stock, restricted stock units, and employee stock purchase plan shares that are ultimately expected to vest as the requisite service is rendered beginning on September 25, 2005, the first day of the Company's fiscal year 2006. Stock-based compensation expense for awards granted prior to September 25, 2005 is based on the grant date fair-value as determined under the pro forma provisions of SFAS No. 123. The Company recorded incremental stock-based compensation expense of $26 million and $58 million during the second quarter and first six months of 2006, respectively, as a result of the adoption of SFAS No. 123R. In accordance with SFAS No. 123R, beginning in the first quarter of 2006 the Company has presented excess tax benefits from the exercise of stock-based compensation awards as a financing activity in the condensed consolidated statement of cash flows.

No stock-based compensation costs were capitalized as part of the cost of an asset as of April 1, 2006. The income tax benefit related to stock-based compensation expense was $12 million and $26 million for the three and six-month periods ended April 1, 2006, respectively. As of April 1, 2006, $400 million of total unrecognized compensation cost related to stock options and restricted stock units is expected to be recognized over a weighted-average period of 2.55 years.

Prior to the adoption of SFAS No. 123R, the Company measured compensation expense for its employee stock-based compensation plans using the intrinsic value method prescribed by APB Opinion No. 25. The Company applied the disclosure provisions of SFAS No. 123 as amended by SFAS No. 148, *Accounting for Stock-Based Compensation – Transition and Disclosure,* as if the fair-value-based method had been applied in measuring compensation expense. Under APB Opinion No. 25, when the exercise price of the Company's employee stock options was equal to the market price of the underlying stock on the date of the grant, no compensation expense was recognized.

The following table illustrates the effect on net income after taxes and net income per common share as if the Company had applied the fair value recognition provisions of SFAS No. 123 to stock-based compensation during the three and six-month periods ended March 26, 2005 (in millions, except per share amounts):

	Three Months Ended 3/26/05	Six Months Ended 3/26/05
Net income – as reported	$ 290	$ 585
Add: Stock-based employee compensation expense included in reported net income, net of tax	9	18
Deduct: Stock-based employee compensation expense determined under the fair value based method for all awards, net of tax	(27)	(56)
Net income – pro forma	$ 272	$ 547
Net income per common share – as reported		
Basic	$ 0.36	$ 0.73
Diluted	$ 0.34	$ 0.69
Net income per common share – pro forma		
Basic	$ 0.34	$ 0.68
Diluted	$ 0.32	$ 0.64

Source: APPLE COMPUTER INC, 10-Q, May 05, 2006

Further information regarding stock-based compensation can be found in Note 6 of these Notes to Condensed Consolidated Financial Statements.

Earnings Per Share

Basic earnings per common share is computed by dividing income available to common shareholders by the weighted-average number of shares of common stock outstanding during the period. Diluted earnings per common share is computed by dividing income available to common shareholders by the weighted-average number of shares of common stock outstanding during the period increased to include the number of additional shares of common stock that would have been outstanding if the dilutive potential shares of common stock had been issued. The dilutive effect of outstanding options, restricted stock and restricted stock units is reflected in diluted earnings per share by application of the treasury stock method. Under the treasury stock method, an increase in the fair market value of the Company's common stock can result in a greater dilutive effect from outstanding options, restricted stock, and restricted stock units. Additionally, the exercise of employee stock options and the vesting of restricted stock and restricted stock units can result in a greater dilutive effect on earnings per share.

The following table sets forth the computation of basic and diluted earnings per share (in thousands, except net income and per share amounts):

	Three Months Ended		Six Months Ended	
	4/1/06	3/26/05	4/1/06	3/26/05
Numerator (in millions):				
Net income	$ 410	$ 290	$ 975	$ 585
Denominator:				
Weighted-average shares outstanding, excluding unvested restricted stock	840,910	808,172	835,658	798,602
Effect of dilutive options, restricted stock units, and restricted stock	37,627	48,839	40,067	49,951
Denominator for diluted earnings per share	878,537	857,011	875,725	848,553
Basic earnings per share	$ 0.49	$ 0.36	$ 1.17	$ 0.73
Diluted earnings per share	$ 0.47	$ 0.34	$ 1.11	$ 0.69

Potentially dilutive securities representing approximately 1.5 million and 0.9 million shares of common stock for the quarters ended April 1, 2006 and March 26, 2005, respectively, and 3.3 million and 1.1 million shares of common stock for the six months ended April 1, 2006 and March 26, 2005, respectively, were excluded from the computation of diluted earnings per share for these periods because their effect would have been antidilutive. Potentially dilutive securities include stock options, restricted stock units, and restricted stock.

Source: APPLE COMPUTER INC, 10-Q, May 05, 2006

Note 2 – Financial Instruments

Cash, Cash Equivalents and Short–Term Investments

The following table summarizes the fair value of the Company's cash and available–for–sale securities held in its short–term investment portfolio, recorded as cash and cash equivalents or short–term investments as of April 1, 2006, and September 24, 2005 (in millions):

	4/1/06	9/24/05
Cash	$ 477	$ 127
U.S. Treasury and Agency securities	35	89
U.S. corporate securities	3,600	2,030
Foreign securities	2,234	1,245
Total cash equivalents	5,869	3,364
U.S. Treasury and Agency securities	437	216
U.S. corporate securities	1,232	3,662
Foreign securities	211	892
Total short–term investments	1,880	4,770
Total cash, cash equivalents, and short–term investments	$ 8,226	$ 8,261

The Company's U.S. corporate securities consist primarily of commercial paper, certificates of deposit, time deposits, and corporate debt securities. Foreign securities consist primarily of foreign commercial paper, certificates of deposit, and time deposits with foreign institutions, most of which are denominated in U.S. dollars. The Company had net unrealized losses totaling $5.3 million on its investment portfolio, the majority of which related to investments with stated maturities less than one year as of April 1, 2006, and net unrealized losses of $5.9 million on its investment portfolio, approximately half of which related to investments with stated maturities less than one year as of September 24, 2005.

As of April 1, 2006 and September 24, 2005, approximately $76 million and $287 million, respectively, of the Company's short–term investments had underlying maturities ranging from 1 to 5 years. The remaining short–term investments had maturities of 3 to 12 months.

The following table shows the gross unrealized losses and fair value of the Company's investments with unrealized losses that are not deemed to be other–than–temporarily impaired, aggregated by investment category and the length of time that individual securities have been in a continuous unrealized loss position at April 1, 2006 (in millions):

	Less than 12 Months		12 Months or Greater		Total	
Security Description	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
U.S. Treasury and Agency Securities	$ 390	$ (1)	$ 52	$ —	$ 442	$ (1)
U.S. corporate securities	2,582	(2)	201	(2)	2,783	(4)
Foreign securities	777	—	29	(1)	806	(1)
Total	$ 3,749	$ (3)	$ 282	$ (3)	$ 4,031	$ (6)

The unrealized losses on the Company's investments in U.S. Treasury and Agency securities, U.S. corporate securities, and foreign securities were caused primarily by changes in interest rates. The Company typically invests in highly rated securities with low probabilities of default. The Company's investment policy requires investments to be rated single–A or better. Therefore, the Company considers the declines to be temporary in nature. As of April 1, 2006, the Company does not consider the investments to be other–than–temporarily impaired.

Market values were determined for each individual security in the investment portfolio. When evaluating the investments, the Company reviews factors such as the length of time and extent to which fair value has been below cost basis, the financial condition of the issuer, and the Company's ability and intent to hold the investment for a period of time which may be sufficient for anticipated recovery in market value.

Source: APPLE COMPUTER INC, 10-Q, May 05, 2006

Derivative Financial Instruments

The Company uses derivatives to partially offset its business exposure to foreign exchange and interest rate risk. Foreign currency forward and option contracts are used to offset the foreign exchange risk on certain existing assets and liabilities and to hedge the foreign exchange risk on expected future cash flows on certain forecasted revenue and cost of sales. From time to time, the Company enters into interest rate derivative agreements to modify the interest rate profile of certain investments and debt. The Company's accounting policies for these instruments are based on whether the instruments are designated as hedge or non-hedge instruments. The Company records all derivatives on the balance sheet at fair value. Derivatives that are not hedges are adjusted to fair value through earnings. If the derivative is a hedge, depending on the nature of the hedge, changes in fair value will either be offset against the change in fair value of the hedged assets, liabilities, or firm commitments through earnings, or recognized in other comprehensive income until the hedged item is recognized in earnings. As of April 1, 2006, the Company had a net deferred gain associated with cash flow hedges of approximately $1 million net of taxes, substantially all of which is expected to be reclassified to earnings by the end of the fourth quarter of fiscal 2006. As of the end of the second quarter of 2006, the general nature of the Company's risk management activities and the general nature and mix of the Company's derivative financial instruments have not changed materially from the end of 2005.

Foreign Exchange Risk Management

The Company may enter into foreign currency forward and option contracts with financial institutions to protect against foreign exchange risk associated with existing assets and liabilities, certain firm commitments, forecasted future cash flows, and net investments in foreign subsidiaries. Generally, the Company's practice is to hedge a majority of its existing material foreign exchange transaction exposures. However, the Company may not hedge certain foreign exchange transaction exposures due to immateriality, prohibitive economic cost of hedging particular exposures, or limited availability of appropriate hedging instruments.

Note 3 – Condensed Consolidated Financial Statement Details (in millions)

Other Current Assets

	4/1/06	9/24/05
Vendor non-trade receivables	$ 1,123	$ 417
NAND flash memory prepayments	97	—
Other current assets	316	231
Total other current assets	$ 1,536	$ 648

Property, Plant, and Equipment, Net

	4/1/06	9/24/05
Land and buildings	$ 485	$ 361
Machinery, equipment, and internal-use software	525	470
Office furniture and equipment	87	81
Leasehold improvements	634	569
	1,731	1,481
Accumulated depreciation and amortization	(726)	(664)
Total property, plant, and equipment, net	$ 1,005	$ 817

Other Assets

	4/1/06	9/24/05
Long-term NAND flash memory prepayments	$ 1,153	$ —
Non-current deferred tax assets	134	183
Capitalized software development costs, net	29	38
Other assets	194	117
Total other assets	$ 1,510	$ 338

Source: APPLE COMPUTER INC, 10-Q, May 05, 2006

Accrued Expenses

	4/1/06	9/24/05
Deferred revenue – current	$ 634	$ 501
Accrued marketing and distribution	196	221
Accrued compensation and employee benefits	197	167
Accrued warranty and related costs	255	188
Deferred margin on component sales	350	26
Other current liabilities	716	602
Total accrued expenses	$ 2,348	$ 1,705

Non–Current Liabilities

	4/1/06	9/24/05
Deferred revenue – non–current	$ 300	$ 281
Deferred tax liabilities	460	308
Other non–current liabilities	13	12
Total non–current liabilities	$ 773	$ 601

Other Income and Expense

	Three Months Ended		Six Months Ended	
	4/1/06	3/26/05	4/1/06	3/26/05
Interest income	$ 87	$ 39	$ 175	$ 67
Other expense, net	(11)	(6)	(18)	(8)
Other income and expense	$ 76	$ 33	$ 157	$ 59

Note 4 – Restructuring Actions

2004 and 2003 Restructuring Actions

The Company recorded total restructuring charges of approximately $23.0 million during 2004, including approximately $14.0 million in severance costs, $5.5 million in asset impairments, and a $3.5 million charge for lease cancellations in conjunction with the vacating of a leased sales facility related to a European workforce reduction during the fourth quarter of 2004. Of the $23.0 million charge, $20.7 million had been utilized by the end of the second quarter of 2006, with the remaining $2.3 million consisting of $0.2 million for employee severance benefits and $2.1 million for lease cancellations. These actions have resulted in the termination of 451 positions.

The following table summarizes activity associated with restructuring actions initiated during 2004 (in millions):

	Employee Severance Benefits	Asset Impairments	Lease Cancellations	Totals
Total charge	$ 14.0	$ 5.5	$ 3.5	$ 23.0
Total spending through April 1, 2006	(12.5)	—	(1.4)	(13.9)
Total non–cash items	—	(5.2)	—	(5.2)
Adjustments	(1.3)	(0.3)	—	(1.6)
Accrual at April 1, 2006	$ 0.2	$ —	$ 2.1	$ 2.3

The Company recorded total restructuring charges of approximately $26.8 million during 2003, including approximately $7.4 million in severance costs, a $5.0 million charge to write off deferred compensation, $7.1 million in asset impairments and a $7.3 million charge for lease cancellations primarily related to the closure of the Company's Singapore manufacturing operations during the first

quarter of 2003. Of the $26.8 million charge, all had been utilized by the end of the second quarter of 2006, except for approximately $1.5 million related to operating lease costs on abandoned facilities.

Source: APPLE COMPUTER INC, 10-Q, May 05, 2006

The following table summarizes activity associated with restructuring actions initiated during 2003 (in millions):

	Employee Severance Benefits	Deferred Compensation Write-off	Asset Impairments	Lease Cancellations	Totals
Total charge	$ 7.4	$ 5.0	$ 7.1	$ 7.3	$ 26.8
Total spending through April 1, 2006	(7.9)	—	—	(5.3)	(13.2)
Total non-cash items	—	(5.0)	(7.1)	—	(12.1)
Adjustments	0.5	—	—	(0.5)	—
Accrual at April 1, 2006	$ —	$ —	$ —	$ 1.5	$ 1.5

Note 5 – Shareholders' Equity

Preferred Stock
The Company has five million shares of authorized preferred stock, none of which is outstanding. Under the terms of the Company's Restated Articles of Incorporation, the Board of Directors is authorized to determine or alter the rights, preferences, privileges and restrictions of the Company's authorized but unissued shares of preferred stock.

Restricted Stock Units
The Company's Board of Directors has granted restricted stock units to members of the Company's senior management team, excluding its CEO. These restricted stock units generally vest over four years either at the end of the four-year service period, in two equal installments on the second and fourth anniversaries of the date of grant, or in equal installments on each of the first through fourth anniversaries of the grant date. Upon vesting, the restricted stock units will convert into an equivalent number of shares of common stock. The amounts of the restricted stock units expensed by the Company are based on the closing market price of the Company's common stock on the date of grant and are amortized on a straight-line basis over the four-year requisite service period. The restricted stock units have been reflected in the calculation of diluted earnings per share utilizing the treasury stock method.

During the second quarter of 2006, 2.4 million of previously granted restricted stock units vested. A majority of these vested restricted stock units were net-share settled such that the Company withheld shares with value equivalent to the employees' minimum statutory obligation for the applicable income and other employment taxes, and remitted the cash to the appropriate taxing authorities. The total shares withheld of 954,079 was based on the value of the restricted stock units on their vesting date as determined by the Company's closing stock price of $59.96. Total payments for the employees' tax obligations to the taxing authorities were approximately $57 million. These net-share settlements had the effect of share repurchases by the Company as they reduced and retired the number of shares that would have otherwise been issued as a result of the vesting and did not represent an expense to the Company.

CEO Restricted Stock Award
On March 19, 2003, the Company's Board of Directors granted 10 million shares of restricted stock to the Company's CEO that vested on March 19, 2006. The amount of the restricted stock award expensed by the Company was based on the closing market price of the Company's common stock on the date of grant and was amortized on a straight-line basis over the three-year requisite service period.

Upon vesting during the second quarter of 2006, the restricted stock award was net-share settled such that the Company withheld shares with value equivalent to the CEO's minimum statutory obligation for the applicable income and other employment taxes, and remitted the cash to the appropriate taxing authorities. The total shares withheld of 4.6 million was based on the value of the restricted stock award on the vesting date as determined by the Company's closing stock price of $64.66. The remaining shares net of those withheld were delivered to the Company's CEO. Total payments for the CEO's tax obligations to the taxing authorities were approximately $296 million. The net-share settlement had the effect of share repurchases by the Company as they reduced and retired the number of shares outstanding and did not represent an expense to the Company.

Source: APPLE COMPUTER INC, 10-Q, May 05, 2006

Stock Repurchase Plan
In July 1999, the Company's Board of Directors authorized a plan for the Company to repurchase up to $500 million of its common stock. This repurchase plan does not obligate the Company to acquire any specific number of shares or acquire shares over any specified period of time.

During the second quarter of 2006, the Company withheld a total of 4.6 million shares of its common stock at a price of $64.66 per share related to the net-share settlement upon vesting of restricted stock to pay the CEO's minimum statutory obligation for the applicable income and other employment taxes. This share withholding was not part of the Company's authorized stock repurchase plan. Other than this net-share settlement, the Company has not engaged in any transactions to repurchase its common stock since 2001. The Company has repurchased a total of 13.1 million shares at a cost of $217 million under this plan and was authorized to repurchase up to an additional $283 million of its common stock as of April 1, 2006.

Comprehensive Income
Comprehensive income consists of two components, net income and other comprehensive income. Other comprehensive income refers to revenue, expenses, gains, and losses that under U.S. generally accepted accounting principles are recorded as an element of shareholders' equity but are excluded from net income. The Company's other comprehensive income consists of foreign currency translation adjustments from those subsidiaries not using the U.S. dollar as their functional currency, unrealized gains and losses on marketable securities categorized as available-for-sale, and net deferred gains and losses on certain derivative instruments accounted for as cash flow hedges.

The following table summarizes components of total comprehensive income, net of taxes, during the three and six-month periods ended April 1, 2006 and March 26, 2005 (in millions):

	Three Months Ended		Six Months Ended	
	4/1/06	3/26/05	4/1/06	3/26/05
Net income	$ 410	$ 290	$ 975	$ 585
Other comprehensive income:				
Net change in unrealized derivative gains/losses	(5)	17	(3)	8
Change in foreign currency translation	5	(7)	(3)	15
Net change in unrealized investment gains/losses	—	(1)	1	(2)
Total comprehensive income	$ 410	$ 299	$ 970	$ 606

The following table summarizes the components of accumulated other comprehensive income (loss), net of taxes (in millions):

	As of 4/1/06	As of 9/24/05
Unrealized gains (losses) on derivative investments	$ 1	$ 4
Cumulative foreign currency translation	(3)	—
Unrealized losses on available-for-sale securities	(3)	(4)
Accumulated other comprehensive income (loss)	$ (5)	$ —

Source: APPLE COMPUTER INC, 10-Q, May 05, 2006

The following table summarizes activity in other comprehensive income related to derivatives, net of taxes, held by the Company during the three and six-month periods ended April 1, 2006 and March 26, 2005 (in millions):

	Three Months Ended		Six Months Ended	
	4/1/06	3/26/05	4/1/06	3/26/05
Change in fair value of derivatives	$ 2	$ 4	$ 7	$ (8)
Adjustment for net gains (losses) realized and included in net income	(7)	13	(10)	16
Change in unrealized derivative gains (losses)	$ (5)	$ 17	$ (3)	$ 8

Employee Benefit Plans

2003 Employee Stock Option Plan
The 2003 Employee Stock Plan (the 2003 Plan) is a shareholder approved plan that provides for broad-based grants to employees, including executive officers. Based on the terms of individual option grants, options granted under the 2003 Plan generally expire 7 to 10 years after the grant date and generally become exercisable over a period of four years, based on continued employment, with either annual or quarterly vesting. The 2003 Plan permits the granting of incentive stock options, nonstatutory stock options, restricted stock units, stock appreciation rights, and stock purchase rights.

1997 Employee Stock Option Plan
In August 1997, the Company's Board of Directors approved the 1997 Employee Stock Option Plan (the 1997 Plan), a non-shareholder approved plan for grants of stock options to employees who are not officers of the Company. Based on the terms of individual option grants, options granted under the 1997 Plan generally expire 7 to 10 years after the grant date and generally become exercisable over a period of four years, based on continued employment, with either annual or quarterly vesting. In October 2003, the Company terminated the 1997 Plan and no new options can be granted from this plan.

1997 Director Stock Option Plan
In August 1997, the Company's Board of Directors adopted a shareholder approved Director Stock Option Plan (DSOP) for non-employee directors of the Company. Initial grants of 30,000 options under the DSOP vest in three equal installments on each of the first through third anniversaries of the date of grant, and subsequent annual grants of 10,000 options are fully vested at the date of grant. Based on the terms of individual option grants, options granted under the DSOP generally expire 10 years after the grant date.

Rule 10b5-1 Trading Plans
Certain of the Company's executive officers, including Mr. Timothy D. Cook, Ms. Nancy R. Heinen, Mr. Peter Oppenheimer, Mr. Jonathan Rubinstein, Mr. Philip W. Schiller, Dr. Bertrand Serlet, and Dr. Avadis Tevanian, Jr. (formerly an executive officer), have entered into trading plans pursuant to Rule 10b5-1(c)(1) of the Securities Exchange Act of 1934, as amended. A trading plan is a written document that pre-establishes the amounts, prices and dates (or formula for determining the amounts, prices and dates) of future purchases or sales of the Company's stock including the exercise and sale of employee stock options and shares acquired pursuant to the Company's employee stock purchase plan and upon vesting of restricted stock units.

Employee Stock Purchase Plan
The Company has a shareholder approved employee stock purchase plan (the Purchase Plan), under which substantially all employees may purchase common stock through payroll deductions at a price equal to 85% of the lower of the fair market values as of the beginning and end of six-month offering periods. Stock purchases under the Purchase Plan are limited to 10% of an employee's compensation, up to a maximum of $25,000 in any calendar year. The number of shares authorized for issuance is limited to a total of one million shares per offering period. As of April 1, 2006, approximately 2.9 million shares were reserved for future issuance under the Purchase Plan.

Source: APPLE COMPUTER INC, 10-Q, May 05, 2006

Stock Award Activity

A summary of the Company's stock award activity and related information for the six-month periods ended April 1, 2006 and March 26, 2005 (stock award amounts are presented in thousands) is set forth in the following table:

		Outstanding Options	
	Shares Available For Grant	Number of Shares	Weighted-Average Exercise Price
Balance at 9/25/04	24,050	110,722	$ 10.52
Options Granted	(3,798)	3,798	$ 32.72
Options and Restricted Stock Units Canceled	2,232	(2,232)	$ 10.80
Options Exercised	—	(38,868)	$ 9.96
Plan Shares Expired	(1,030)	—	—
Balance at 3/26/05	21,454	73,420	$ 11.96
Balance at 9/24/05	58,957	73,221	$ 17.79
Options Granted	(1,907)	1,907	$ 66.32
Restricted Stock Units Granted	(2,700)	—	—
Options Canceled	1,324	(1,324)	$ 25.23
Restricted Stock Units Canceled	200	—	—
Options Exercised	—	(16,402)	$ 11.21
Plan Shares Expired	(69)	—	—
Vested and Expected to Vest Balance at 4/1/06	55,805	57,402	$ 21.11

The weighted average remaining contractual life of options outstanding and exercisable was 5.16 years and 4.68 years, respectively, as of April 1, 2006. The options outstanding as of April 1, 2006 have been segregated into six ranges for additional disclosure as follows (option amounts are presented in thousands):

	Options Outstanding		Options Exercisable	
Range of Exercise Prices	Options Outstanding as of 4/1/06	Weighted-Average Exercise Price	Options Exercisable as of 4/1/06	Weighted-Average Exercise Price
$0.62 – $9.25	10,067	$ 7.90	9,151	$ 7.92
$9.26 – $10.73	7,461	$ 10.15	6,168	$ 10.15
$10.74 – $10.90	10,091	$ 10.89	3,294	$ 10.89
$10.91 – $14.91	9,572	$ 11.75	7,973	$ 11.58
$14.92 – $46.10	8,157	$ 28.62	3,327	$ 25.65
$46.11 – $84.29	12,054	$ 49.83	1,108	$ 46.73
$0.62 – $84.29	57,402	$ 21.11	31,021	$ 12.91

Aggregate intrinsic value of options outstanding and options exercisable at April 1, 2006 was $2.4 billion and $1.5 billion, respectively. Aggregate intrinsic value represents the value of the Company's closing stock price on the last trading day of the fiscal period in excess of the exercise price multiplied by the number of options outstanding or exercisable. Total intrinsic value of options exercised was $414 million and $887 million for the three and six-month periods ended April 1, 2006, respectively, and $373 million and $767 million for the three and six-month periods ended March 26, 2005, respectively.

The Company had 3.98 million restricted stock units with a total grant date fair value of $138 million outstanding, as of April 1, 2006, which were excluded from the options outstanding balances in the preceding tables. Aggregate

Source: APPLE COMPUTER INC, 10-Q, May 05, 2006

intrinsic value of unvested restricted stock units at April 1, 2006 was $250 million. The total fair value of restricted stock units vested during the quarter ended April 1, 2006 was $143.9 million. Granted restricted stock units have been deducted from the shares available for grant under the Company's stock option plans. In conjunction with the amendments to the 2003 Plan that were approved at the Annual Meeting of Shareholders held on April 21, 2005, the number of shares available for grant under the 2003 Plan will be reduced by two times the number of restricted shares and restricted stock units granted. This amendment is effective for all grants made after April 21, 2005.

The total fair value of restricted stock vested during the quarter ended April 1, 2006 was $646.6 million. There were no grants or forfeitures of any restricted stock during the three or six months ended April 1, 2006 and as of April 1, 2006, there was no unvested restricted stock outstanding. For the three and six-month periods ended April 1, 2006, total compensation cost recognized related to restricted stock was $2.3 million and $4.6 million, respectively. For the three and six-month periods ended March 26, 2005, total compensation cost recognized related to the nonvested restricted stock was $6.2 million and $12.5 million, respectively.

Note 6 – Stock-Based Compensation

SFAS No. 123R requires the use of a valuation model to calculate the fair value of stock-based awards. The Company has elected to use the BSM option-pricing model, which incorporates various assumptions including volatility, expected life, and interest rates. The expected volatility is based on the historical volatility of the Company's common stock over the most recent period commensurate with the estimated expected life of the Company's stock options, adjusted for the impact of unusual fluctuations not reasonably expected to recur and other relevant factors including implied volatility in market traded options on the Company's common stock. The expected life of an award is based on historical experience and on the terms and conditions of the stock awards granted to employees.

The weighted average assumptions used for the three and six-month periods ended April 1, 2006 and March 26, 2005 and the resulting estimates of weighted-average fair value per share of options granted and for stock purchases during those periods are as follows:

	Three Months Ended		Six Months Ended	
	4/1/06	3/26/05	4/1/06	3/26/05
Expected life of stock options	3.54 years	3.50 years	3.58 years	3.50 years
Expected life of stock purchases	6 months	6 months	6 months	6 months
Interest rate – stock options	4.53%	3.70%	4.32%	3.37%
Interest rate – stock purchases	4.46%	2.54%	3.73%	2.11%
Volatility – stock options	40.80%	40.00%	40.74%	40.00%
Volatility – stock purchases	31.39%	41.12%	42.04%	36.52%
Expected dividend yields	—	—	—	—
Weighted-average fair value of options granted during the period	$ 25.62	$ 13.54	$ 23.52	$ 10.94
Weighted-average fair value of employee stock purchases during the period	$ 16.82	$ 7.30	$ 12.60	$ 5.53

Note 7 – Commitments and Contingencies

Lease Commitments

The Company leases various equipment and facilities, including retail space, under noncancelable operating lease arrangements. The Company does not currently utilize any other off-balance sheet financing arrangements. The major facility leases are for terms of 5 to 15 years and generally provide renewal options for terms of 3 to 5 additional years. Leases for retail space are for terms of 5 to 20 years, the majority of which are for 10 years, and often contain multi-year renewal options. As of September 24, 2005, the Company's total future minimum lease payments under noncancelable operating leases were $865 million, of which $606 million related to leases for retail space. As of April 1, 2006, total future minimum lease payments related to leases for retail space increased to $782 million.

Source: APPLE COMPUTER INC, 10-Q, May 05, 2006

Accrued Warranty and Indemnifications

The Company offers a basic limited parts and labor warranty on its hardware products. The basic warranty period for hardware products is typically one year from the date of purchase by the end-user. The Company also offers a 90-day basic warranty for its service parts used to repair the Company's hardware products. The Company provides currently for the estimated cost that may be incurred under its basic limited product warranties at the time the related revenue is recognized. Factors considered in determining appropriate accruals for product warranty obligations include the size of the installed base of products subject to warranty protection, historical and projected warranty claim rates, historical and projected cost-per-claim, and knowledge of specific product failures that are outside of the Company's typical experience. The Company assesses the adequacy of its preexisting warranty liabilities and adjusts the amounts as necessary based on actual experience and changes in future estimates.

The following table reconciles changes in the Company's accrued warranties and related costs for the three and six-month periods ended April 1, 2006 and March 26, 2005 (in millions):

	Three Months Ended		Six Months Ended	
	4/1/06	3/26/05	4/1/06	3/26/05
Beginning accrued warranty and related costs	$ 247	$ 135	$ 188	$ 105
Cost of warranty claims	(74)	(43)	(151)	(77)
Accruals for product warranties	82	62	218	126
Ending accrued warranty and related costs	$ 255	$ 154	$ 255	$ 154

The Company generally does not indemnify end-users of its operating system and application software against legal claims that the software infringes third-party intellectual property rights. Other agreements entered into by the Company sometimes include indemnification provisions under which the Company could be subject to costs and/or damages in the event of an infringement claim against the Company or an indemnified third-party. However, the Company has not been required to make any significant payments resulting from such an infringement claim asserted against itself or an indemnified third-party and, in the opinion of management, does not have a potential liability related to unresolved infringement claims subject to indemnification that would have a material adverse effect on its financial condition, liquidity or results of operations. Therefore, the Company did not record a liability for infringement costs as of either April 1, 2006 or September 24, 2005.

Concentrations in the Available Sources of Supply of Materials and Product

Although most components essential to the Company's business are generally available from multiple sources, other key components (including microprocessors and application-specific integrated circuits ("ASICs")) are currently obtained by the Company from single or limited sources. Some other key components, while currently available to the Company from multiple sources, are at times subject to industry-wide availability and pricing pressures. In addition, the Company uses some components that are not common to the rest of the personal computer industry, and new products introduced by the Company often initially utilize custom components obtained from only one source until the Company has evaluated whether there is a need for and subsequently qualifies additional suppliers. If the supply of a key single-sourced component to the Company were to be delayed or curtailed, or in the event a key manufacturing vendor delays shipments of completed products to the Company, the Company's ability to ship related products in desired quantities and in a timely manner could be adversely affected. The Company's business and financial performance could also be adversely affected depending on the time required to obtain sufficient quantities from the original source, or to identify and obtain sufficient quantities from an alternative source. Continued availability of these components may be affected if producers were to decide to concentrate on the production of common components instead of components customized to meet the Company's requirements. Finally, significant portions of the Company's CPUs, logic boards, and assembled products are now manufactured by outsourcing partners, primarily in various parts of Asia. Although the Company works closely with its outsourcing partners on manufacturing schedules, the Company's operating results could be adversely affected if its outsourcing partners were unable to meet their production obligations.

Source: APPLE COMPUTER INC, 10-Q, May 05, 2006

Long–Term Supply Agreements
During the first quarter of 2006, the Company entered into long–term supply agreements with Hynix Semiconductor, Inc., Intel Corporation, Micron Technology, Inc., Samsung Electronics Co., Ltd., and Toshiba Corporation to secure supply of NAND flash memory through calendar year 2010. As part of these agreements, the Company agreed to prepay $1.25 billion for flash memory components of which $750 million was paid during the first quarter of 2006 and the remaining $500 million was paid during the second quarter of 2006. These prepayments will be applied to inventory purchases made over the life of each respective agreement.

Contingencies
The Company is subject to certain other legal proceedings and claims that have arisen in the ordinary course of business and have not been fully adjudicated. In the opinion of management, the Company does not have a potential liability related to any current legal proceedings and claims that would individually or in the aggregate have a material adverse effect on its financial condition, liquidity, or results of operations. However, the results of legal proceedings cannot be predicted with certainty. Should the Company fail to prevail in any of these legal matters or should several of these legal matters be resolved against the Company in the same reporting period, the operating results of a particular reporting period could be materially adversely affected.

Production and marketing of products in certain states and countries may subject the Company to environmental and other regulations including, in some instances, the requirement to provide customers the ability to return product at the end of its useful life, and place responsibility for environmentally safe disposal or recycling with the Company. Such laws and regulations have recently been passed in several jurisdictions in which the Company operates including various European Union member countries, Japan and certain states within the U.S. Although the Company does not anticipate any material adverse effects in the future based on the nature of its operations and the thrust of such laws, there is no assurance that such existing laws or future laws will not have a material adverse effect on the Company's financial condition, liquidity, or results of operations.

Note 8 – Segment Information and Geographic Data

In accordance with SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*, the Company reports segment information based on the "management" approach. The management approach designates the internal reporting used by management for making decisions and assessing performance as the source of the Company's reportable segments.

The Company manages its business primarily on a geographic basis. The Company's reportable operating segments are comprised of the Americas, Europe, Japan, and Retail. The Americas, Europe, and Japan reportable segments do not include activities related to the Retail segment. The Americas segment includes both North and South America. The Europe segment includes European countries as well as the Middle East and Africa. The Retail segment operates Apple–owned retail stores in the U.S., Canada, Japan, and the U.K. Other operating segments include Asia–Pacific, which includes Australia and Asia except for Japan, and the Company's subsidiary, FileMaker, Inc. Each reportable geographic operating segment provides similar hardware and software products and similar services, and the accounting policies of the various segments are the same as those described in the Company's 2005 Form 10–K in Note 1, "Summary of Significant Accounting Policies," except as described below for the Retail segment.

The Company evaluates the performance of its operating segments based on net sales. The Retail segment's performance is also evaluated based on operating income. Net sales for geographic segments are generally based on the location of the customers. Operating income for each segment includes net sales to third parties, related cost of sales, and operating expenses directly attributable to the segment. Operating income for each segment excludes other income and expense and certain expenses that are managed outside the operating segments. Costs excluded from segment operating income include various corporate expenses such as manufacturing costs and variances not included in standard costs, research and development, corporate marketing expenses, stock–based compensation expense, income taxes, various nonrecurring charges, and other separately managed general and administrative expenses including certain corporate expenses associated with support of the Retail segment. The Company does not include intercompany transfers between segments for management reporting purposes. Segment assets exclude corporate assets. Corporate assets include cash, short–term and long–term investments, manufacturing facilities, miscellaneous corporate infrastructure, goodwill and other acquired intangible assets, and retail store construction–in–progress that is not subject to depreciation. Except for the Retail segment, capital expenditures for long–lived assets are not reported to management by segment. Capital expenditures by the Retail segment were $42 million and

Source: APPLE COMPUTER INC, 10-Q, May 05, 2006

$16 million during the second quarters of 2006 and 2005, respectively, and $82 million and $49 million during the first six months of 2006 and 2005, respectively.

Operating income for all segments, except Retail, includes cost of sales at manufacturing standard cost, other cost of sales, related sales and marketing costs, and certain general and administrative costs. This measure of operating income, which includes manufacturing profit, provides a comparable basis for comparison between the Company's various geographic segments. Certain manufacturing expenses and related adjustments not included in segment cost of sales, including variances between standard and actual manufacturing costs and the mark-up above standard cost for product supplied to the Retail segment, are included in corporate expenses.

Management assesses the operating performance of the Retail segment differently than it assesses the operating performance of the Company's geographic segments. The Retail segment revenue and operating income is intended to depict a measure comparable to that of the Company's major channel partners in the U.S. operating retail stores so the Company can evaluate the Retail segment performance as if it were a channel partner. Therefore, the Company makes three significant adjustments to the Retail segment for management reporting purposes that are not included in the results of the Company's other segments.

First, the Retail segment's operating income includes cost of sales for Apple products at an amount normally charged to major channel partners in the U.S. operating retail stores, less the cost of sales programs and incentives provided to those channel partners and the Company's cost to support those partners. For the second quarter of 2006 and 2005, this resulted in the recognition of additional cost of sales above standard cost by the Retail segment and an offsetting benefit to corporate expenses of approximately $128 million and $102 million, respectively, and for the first six months of 2006 and 2005, approximately $327 million and $201 million, respectively.

Second, the Company's service and support contracts are transferred to the Retail segment at the same cost as that charged to the Company's major retail channel partners in the U.S., resulting in a measure of revenue and gross margin for those items that is comparable between the Company's Retail stores and those retail channel partners. The Retail segment recognizes the full amount of revenue and cost of sales of the Company's service and support contracts at the time of sale. Because the Company has not yet earned the revenue or incurred the costs associated with the sale of these contracts, an offset to these amounts is recognized in other operating segments' net sales and cost of sales. For the second quarter of 2006, this resulted in the recognition of net sales and cost of sales by the Retail segment, with corresponding offsets in other operating segments, of $29 million and $20 million, respectively. For the second quarter of 2005, the net sales and cost of sales of extended warranty, support and service contracts recognized by the Retail segment were $21 million and $15 million, respectively. For the first six months of 2006, this resulted in the recognition of additional net sales and cost of sales by the Retail segment, with corresponding offsets in other operating segments, of $67 million and $45 million, respectively. This compares to similar adjustments to net sales and cost of sales during the first six months of 2005 of $41 million and $28 million, respectively.

Third, the Company has opened seven high profile stores in New York; Los Angeles; Chicago; San Francisco; Tokyo, Japan; Osaka, Japan; and London, England as of April 1, 2006. These high profile stores are larger than the Company's typical retail stores and were designed to further promote brand awareness and provide a venue for certain corporate sales and marketing activities, including corporate briefings. As such, the Company allocates certain operating expenses associated with these stores to corporate marketing expense to reflect the estimated benefit realized Company-wide. The allocation of these operating costs is based on the amount incurred for a high profile store in excess of that incurred by a more typical Company retail location. Expenses allocated to corporate marketing resulting from the operations of these stores were $7.6 million and $7.1 million in the second quarters of 2006 and 2005, respectively, and $15.2 million and $14.0 million for the first six months of 2006 and 2005, respectively.

Source: APPLE COMPUTER INC, 10-Q, May 05, 2006

Summary information by operating segment is as follows (in millions):

	Three Months Ended		Six Months Ended	
	4/1/06	3/26/05	4/1/06	3/26/05
Americas:				
Net sales	$ 2,122	$ 1,443	$ 4,822	$ 3,080
Operating income	$ 390	$ 185	$ 826	$ 387
Europe:				
Net sales	$ 966	$ 705	$ 2,208	$ 1,552
Operating income	$ 126	$ 100	$ 300	$ 233
Japan:				
Net sales	$ 309	$ 284	$ 664	$ 469
Operating income	$ 57	$ 45	$ 110	$ 66
Retail:				
Net sales	$ 636	$ 571	$ 1,708	$ 1,132
Operating income	$ 29	$ 42	$ 119	$ 87
Other Segments (a):				
Net sales	$ 326	$ 240	$ 706	$ 500
Operating income	$ 61	$ 25	$ 127	$ 62

(a) Other Segments consists of Asia–Pacific and FileMaker.

A reconciliation of the Company's segment operating income to the consolidated financial statements is as follows (in millions):

	Three Months Ended		Six Months Ended	
	4/1/06	3/26/05	4/1/06	3/26/05
Segment operating income	$ 663	$ 397	$ 1,482	$ 835
Retail manufacturing margin (b)	128	102	327	201
Stock–based compensation expense	(42)	(10)	(86)	(20)
Other corporate expenses, net (c)	(220)	(87)	(444)	(211)
Total operating income	$ 529	$ 402	$ 1,279	$ 805

(b) Represents the excess of the Retail segment's cost of sales over the Company's standard cost of sales for products sold through the Retail segment.

(c) Other corporate expenses include research and development, corporate marketing expenses, manufacturing costs and variances not included in standard costs, and other separately managed general and administrative expenses including certain corporate expenses associated with support of the Retail segment.

Note 9 – Related Party Transactions and Certain Other Transactions

In March 2002, the Company entered into a Reimbursement Agreement with its CEO, Mr. Steven P. Jobs, for the reimbursement of expenses incurred by Mr. Jobs in the operation of his private plane when used for Apple business. The Reimbursement Agreement became effective for expenses incurred by Mr. Jobs for Apple business purposes since he took delivery of the plane in May 2001. The Company did not recognize any expense pursuant to the Reimbursement Agreement during the three and six–month periods ended April 1, 2006. The Company recognized a total of $62,000 and $481,000 in expenses pursuant to the Reimbursement Agreement during the three and six–month periods ended March 26, 2005. All expenses recognized pursuant to the Reimbursement Agreement have been included in selling, general, and administrative expenses in the condensed consolidated statements of operations.

In the first quarter of 2006, the Company entered into an agreement with Pixar to sell certain of Pixar's short films on the iTunes Music Store. Mr. Steven P. Jobs, the Company's CEO is also the CEO, Chairman, and a large shareholder of Pixar. During the three and six–month periods ended April 1, 2006 the Company recognized less than $1 million in total royalty expense under this arrangement.

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

This section and other parts of this Form 10-Q contain forward-looking statements that involve risks and uncertainties. Forward-looking statements can be identified by words such as "anticipates," "expects," "believes," "plans," "predicts," and similar terms. Forward-looking statements are not guarantees of future performance and the Company's actual results may differ significantly from the results discussed in the forward-looking statements. Factors that might cause such differences include, but are not limited to, those discussed in Part II, Item 1A. Risk Factors. The following discussion should be read in conjunction with the 2005 Form 10-K and the condensed consolidated financial statements and notes thereto included elsewhere in this Form 10-Q. All information is based on the Company's fiscal calendar. Unless otherwise stated, references in this report to particular years or quarters refer to the Company's fiscal years ended in September and the associated quarters of those fiscal years. The Company assumes no obligation to revise or update any forward-looking statements for any reason, except as required by law.

Available Information

The Company's Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and amendments to reports filed pursuant to Sections 13(a) and 15(d) of the Securities Exchange Act of 1934, as amended, are available on its website at http://www.apple.com/investor when such reports are available on the Securities and Exchange Commission (SEC) website. The public may read and copy any materials filed by the Company with the SEC at the SEC's Public Reference Room at 100 F Street, NE, Room 1580, Washington, DC 20549. The public may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. The SEC maintains an Internet site that contains reports, proxy and information statements and other information regarding issuers that file electronically with the SEC at http://www.sec.gov. The contents of these websites are not incorporated into this filing. Further, the Company's references to the URLs for these websites are intended to be inactive textual references only.

Executive Overview

The Company designs, manufactures, and markets personal computers and related software, services, peripherals, and networking solutions. The Company also designs, develops, and markets a line of portable digital music players along with related accessories and services including the online distribution of third-party music, audio books, music videos, short films, and television shows. The Company's products and services include the Macintosh® line of desktop and portable computers, the iPod® digital music player, the Xserve® G5 server and Xserve RAID storage products, a portfolio of consumer and professional software applications, the Mac OS® X operating system, the iTunes Music Store®, a portfolio of peripherals that support and enhance the Macintosh and iPod product lines, and a variety of other service and support offerings. The Company sells its products worldwide through its online stores, its own retail stores, its direct sales force, and third-party wholesalers, resellers, and value added resellers. In addition, the Company sells a variety of third-party Macintosh compatible products, including computer printers and printing supplies, storage devices, computer memory, digital video camcorders and digital still cameras, personal digital assistants, and various other computing products and supplies through its online and retail stores. The Company sells to education, consumer, creative professional, business, and government customers. A further description of the Company's products may be found below and in Part I, Item 1 of the Company's 2005 Form 10-K.

The Company's business strategy leverages its ability, through the design and development of its own operating system, hardware, and many software applications and technologies, to bring to its customers around the world compelling new products and solutions with superior ease-of-use, seamless integration, and innovative industrial design.

The Company participates in several highly competitive markets, including personal computers with its Macintosh line of computers, consumer electronics with its iPod line of digital music players, and distribution of third-party digital content through its online iTunes Music Store. While the Company is widely recognized as an innovator in the personal computer and consumer electronic markets as well as a leader in the emerging market for distribution of digital content, these are all highly competitive markets that are subject to aggressive pricing and increased competition. To remain competitive, the Company believes that increased investment in research and development (R&D) and marketing and advertising is necessary to maintain and extend its position in the markets where it competes. The Company's R&D spending is focused on delivering timely updates and enhancements to its existing line of personal computers, displays, operating systems, software applications, and portable music players; developing new digital lifestyle consumer and professional software applications; and investing in new product areas

Source: APPLE COMPUTER INC, 10-Q, May 05, 2006

such as wireless technologies. The Company also believes investment in marketing and advertising programs is critical to increasing product and brand awareness.

In June 2005, the Company announced its plan to begin using Intel microprocessors in its Macintosh computers. Through April 1, 2006, the Company had introduced the new iMac®, MacBook™ Pro, and Mac® mini computers, which run on Intel microprocessors. The Company expects to complete the transition of all of its Macintosh computers to Intel microprocessors by the end of calendar year 2006. In April 2006, the Company announced its plans to add a feature to the next version of Mac OS X that will enable Intel-based Macs to run Windows XP. There are potential risks and uncertainties that may occur during this transition, which are further discussed in Part II, Item 1A. Risk Factors.

The Company utilizes a variety of direct and indirect distribution channels. The Company believes that sales of its innovative and differentiated products are enhanced by knowledgeable salespersons who can convey the value of the hardware, software, and peripheral integration, demonstrate the unique digital lifestyle solutions that are available only on Macintosh computers, and demonstrate the compatibility of the Macintosh with the Windows platform and networks. The Company further believes that providing a high-quality sales and after-sales support experience is critical to attracting and retaining customers. To ensure a high-quality buying experience for its products in which service and education are emphasized, the Company has expanded and improved its distribution capabilities by opening its own retail stores in the U.S. and internationally. The Company had 142 stores open as of April 30, 2006.

The Company also staffs selected third-party stores with the Company's own employees and contractors in various geographic locations including the U.S., Europe, Japan, and Australia to improve the buying experience through reseller channels. Additionally, the Company sells to customers directly through its online stores around the world.

The iPod product line can be purchased in certain department stores, member-only warehouse stores, large retail chains, and specialty retail stores, as well as through the channels listed above.

Critical Accounting Policies and Estimates

The preparation of financial statements and related disclosures in conformity with U.S. generally accepted accounting principles and the Company's discussion and analysis of its financial condition and results of operations require the Company's management to make judgments, assumptions, and estimates that affect the amounts reported in its condensed consolidated financial statements and accompanying notes. Note 1 of the Notes to Consolidated Financial Statements in the Company's 2005 Form 10-K describes the significant accounting policies and methods used in the preparation of the Company's consolidated financial statements. Management bases its estimates on historical experience and on various other assumptions it believes to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities. Actual results may differ from these estimates and such differences may be material.

Management believes the Company's critical accounting policies and estimates are those related to revenue recognition, allowance for doubtful accounts, inventory valuation and inventory purchase commitments, warranty costs, stock-based compensation, and income taxes. Management believes these policies to be critical because they are both important to the portrayal of the Company's financial condition and results, and they require management to make judgments and estimates about matters that are inherently uncertain. The Company's senior management has reviewed these critical accounting policies and related disclosures with the Audit and Finance Committee of the Company's Board of Directors.

Revenue Recognition

Net sales consist primarily of revenue from the sale of hardware, software, peripherals, digital content, and service and support contracts. The Company recognizes revenue pursuant to applicable accounting standards, including Statement of Position (SOP) No. 97-2, *Software Revenue Recognition*, as amended, and SEC Staff Accounting Bulletin (SAB) No. 104, *Revenue Recognition.*

The Company recognizes revenue when persuasive evidence of an arrangement exists, delivery has occurred, the sales price is fixed or determinable, and collection is probable. Product is considered delivered to the customer once it has been shipped, and title and risk of loss have been transferred. For most of the Company's product sales, these criteria are met at the time the product is shipped. For online sales to individuals, for some sales to education customers in the U.S., and for certain other sales, the Company defers revenue until the customer receives the

Source: APPLE COMPUTER INC, 10-Q, May 05, 2006

product because the Company retains a portion of the risk of loss on these sales during transit. If at the outset of an arrangement the Company determines the arrangement fee is not, or is presumed not to be, fixed or determinable, revenue is deferred and subsequently recognized as amounts become due and payable.

The Company records reductions to revenue for estimated commitments related to price protection and for customer incentive programs, including reseller and end-user rebates, and other sales programs and volume-based incentives. The estimated cost of these programs is accrued as a reduction to revenue in the period the Company has sold the product and committed to the relevant program. The Company also records reductions to revenue for expected future product returns based on the Company's historical experience. Future market conditions and product transitions may require the Company to increase customer incentive programs and incur incremental price protection obligations that could result in additional reductions to revenue at the time such programs are offered. Additionally, certain customer incentive programs require management to estimate the number of customers who will actually redeem the incentive based on historical experience and the specific terms and conditions of particular incentive programs. If a greater than estimated proportion of customers redeem such incentives, the Company would be required to record additional reductions to revenue, which could have a material adverse impact on the Company's results of operations.

Allowance for Doubtful Accounts
The Company distributes its products through third-party resellers and directly to certain education, consumer, and commercial customers. The Company generally does not require collateral from its customers. However, when possible the Company does attempt to limit credit risk on trade receivables with credit insurance for certain customers in Latin America, Europe, and Asia and by arranging with third-party financing companies to provide flooring arrangements and other loan and lease programs to the Company's direct customers. These credit-financing arrangements are directly between the third-party financing company and the end customer. As such, the Company generally does not assume any recourse or credit risk sharing related to any of these arrangements. However, considerable trade receivables that are not covered by collateral, third-party flooring arrangements, or credit insurance are outstanding with the Company's distribution and retail channel partners.

The allowance for doubtful accounts is based on management's assessment of the collectibility of specific customer accounts and includes consideration of the credit worthiness and financial condition of those specific customers. The Company records an allowance to reduce the specific receivables to the amount that is reasonably believed to be collectible. The Company also records an allowance for all other trade receivables based on multiple factors including historical experience with bad debts, the general economic environment, the financial condition of the Company's distribution channels, and the aging of such receivables. If there is a deterioration of a major customer's financial condition, if the Company becomes aware of additional information related to the credit worthiness of a major customer, or if future actual default rates on trade receivables in general differ from those currently anticipated, the Company may have to adjust its allowance for doubtful accounts, which would affect earnings in the period the adjustments were made.

Inventory Valuation and Inventory Purchase Commitments
The Company must order components for its products and build inventory in advance of product shipments. The Company records a write-down for inventories of components and products, including third-party products held for resale, which have become obsolete or are in excess of anticipated demand or net realizable value. The Company performs a detailed review of inventory each fiscal quarter that considers multiple factors including demand forecasts, product life cycle status, product development plans, current sales levels, and component cost trends. The personal computer and consumer electronic industries are subject to a rapid and unpredictable pace of product and component obsolescence and demand changes. If future demand or market conditions for the Company's products are less favorable than forecasted or if unforeseen technological changes negatively impact the utility of component inventory, the Company may be required to record additional write-downs which would negatively affect gross margins in the period when the write-downs were recorded.

The Company accrues reserves for estimated cancellation fees related to component orders that have been cancelled or are expected to be cancelled. Consistent with industry practice, the Company acquires components through a combination of purchase orders, supplier contracts, and open orders based on projected demand information. These commitments typically cover the Company's requirements for periods ranging from 30 to 150 days. If there is an abrupt and substantial decline in demand for one or more of the Company's products or an unanticipated change in technological requirements for any of the Company's products, the Company may be required to record additional

Source: APPLE COMPUTER INC, 10-Q, May 05, 2006

reserves for cancellation fees that would negatively affect gross margins in the period when the cancellation fees are identified.

Warranty Costs
The Company provides currently for the estimated cost for product warranties at the time the related revenue is recognized based on historical and projected warranty claim rates, historical and projected cost-per-claim, and knowledge of specific product failures that are outside of the Company's typical experience. Each quarter, the Company reevaluates its estimates to assess the adequacy of its recorded warranty liabilities considering the size of the installed base of products subject to warranty protection and adjusts the amounts as necessary. If actual product failure rates or repair costs differ from estimates, revisions to the estimated warranty liability would be required and could negatively affect the Company's results of operations.

Stock-Based Compensation
The Company accounts for stock-based compensation in accordance with Statement of Financial Accounting Standards (SFAS) No. 123R, *Share-Based Payment*. Under the provisions of SFAS No. 123R, stock-based compensation cost is estimated at the grant date based on the award's fair-value as calculated by the Black-Scholes-Merton (BSM) option-pricing model and is recognized as expense ratably over the requisite service period. The BSM model requires various highly judgmental assumptions including volatility, forfeiture rates, and expected option life. If any of the assumptions used in the BSM model change significantly, stock-based compensation expense may differ materially in the future from that recorded in the current period.

Income Taxes
The Company records a tax provision for the anticipated tax consequences of the reported results of operations. In accordance with SFAS No. 109, *Accounting for Income Taxes*, the provision for income taxes is computed using the asset and liability method, under which deferred tax assets and liabilities are recognized for the expected future tax consequences of temporary differences between the financial reporting and tax bases of assets and liabilities, and for operating losses and tax credit carryforwards. Deferred tax assets and liabilities are measured using the currently enacted tax rates that apply to taxable income in effect for the years in which those tax assets are expected to be realized or settled. The Company records a valuation allowance to reduce deferred tax assets to the amount that is believed more likely than not to be realized. The Company is currently evaluating the repatriation provisions of the American Jobs Creation Act of 2004 and other tax planning strategies, which, if implemented by the Company, would affect the Company's tax provision and deferred tax assets and liabilities.

Management believes it is more likely than not that forecasted income, including income that may be generated as a result of certain tax planning strategies, together with the tax effects of the deferred tax liabilities, will be sufficient to fully recover the remaining deferred tax assets. In the event that all or part of the net deferred tax assets are determined not to be realizable in the future, an adjustment to the valuation allowance would be charged to earnings in the period such determination is made. Similarly, if the Company subsequently realizes deferred tax assets that were previously determined to be unrealizable, resulting in a positive adjustment to earnings or a decrease in goodwill in the period such determination is made. In addition, the calculation of tax liabilities involves significant judgment in estimating the impact of uncertainties in the application of complex tax laws. Resolution of these uncertainties in a manner inconsistent with management's expectations could have a material impact on the Company's results of operations and financial position.

Products
The Company offers a range of personal computing products including desktop and portable personal computers, related devices and peripherals, and various third-party hardware products. In addition, the Company offers software products including Mac OS® X, the Company's proprietary operating system software for the Macintosh®; server software and related solutions; professional application software; and consumer, education and business oriented application software. The Company also designs, develops and markets to Macintosh and Windows users its line of iPod® digital music players along with related accessories and services including the online distribution of third-party content through the Company's iTunes Music Store®. A detailed discussion of the Company's products may be found in the 2005 Form 10-K. Certain newly introduced products and/or upgrades to existing products are discussed below.

Through April 1, 2006, the Company had introduced the new iMac®, MacBook™ Pro, and Mac® mini computers, which run on the Intel microprocessors. The iMac, MacBook Pro, and Mac mini feature Mac OS X version 10.4

Source: APPLE COMPUTER INC, 10-Q, May 05, 2006

Tiger, iLife®'06, and the Company's new translation technology, Rosetta®, which allows most PowerPC-based Macintosh applications to run on these new Intel-based Macintosh computers.

iMac®
In January 2006, the Company introduced the new iMac, which is available in a 17-inch widescreen LCD display with a 1.83GHz processor and 160GB Serial ATA hard drive. The iMac is also available in a 20-inch widescreen LCD display with a 2.0 GHz processor and 250GB Serial ATA hard drive. Both models include a built-in iSight™ video camera for video conferencing, Front Row™ with the Apple Remote, 512 MB of 667 MHz DDR2 SDRAM expandable to 2GB, built-in Gigabit Ethernet, 8x SuperDrive™ with double-layer support, and PCI Express-based ATI Radeon X1600 graphics.

MacBook™ Pro
In January 2006, the Company introduced MacBook Pro, which weighs 5.6 pounds and includes a built-in iSight video camera for video conferencing, Front Row, the Apple Remote, two USB 2.0 ports, one FireWire® 400 port, built-in Gigabit Ethernet, built-in AirPort Extreme® 802.11g wireless networking and Bluetooth 2.0+EDR, and a slot-load SuperDrive. The new MacBook Pro offers a 15-inch widescreen LCD display, 667MHz DDR2 SDRAM memory expandable to 2GB, a 1.83GHz or 2.0GHz processor, and also features Apple's new patent-pending MagSafe™ magnetic power adaptor. In April 2006, the Company introduced a 17-inch model of the MacBook Pro.

Mac® mini
In February 2006, the Company introduced the new Mac mini that includes Front Row and the Apple Remote. The new Mac mini offers 512 MB of 667MHz DDR2 SDRAM memory expandable to 2GB and either a 1.5GHz or 1.66GHz processor. Every Mac mini now includes built-in Gigabit Ethernet, AirPort Extreme 802.11g wireless networking, Bluetooth 2.0+EDR, and a total of four USB 2.0 ports. Mac mini includes a DVI interface and a VGA-out adapter to connect to a variety of displays, including televisions, and features both analog, and digital audio outputs.

iPod® nano
In February 2006, the Company added a 1GB iPod nano, which holds up to 240 songs or 15,000 photos, to its 2GB and 4GB iPod nano product family.

iPod Hi-Fi™
In February 2006, the Company introduced iPod Hi-Fi, a high-fidelity speaker system that works with the iPod. iPod Hi-Fi has an all-in-one design that features a built-in Universal iPod Dock, touch-sensitive volume control buttons, the Apple Remote for song and volume control, power supply incorporated into the all-in-one design, and the ability to power the iPod Hi-Fi from batteries. The iPod Hi-Fi also includes a dual-purpose 3.5-mm auxiliary input that accepts either analog or digital signals for connection to a wide range of audio sources.

iPod® Radio Remote
In January 2006, the Company introduced iPod Radio Remote, a wired remote control with FM radio capabilities. The iPod Radio Remote allows users to skip tracks, adjust the volume of their iPods, and listen to FM radio stations while displaying station and song information on their iPod screens.

iLife® '06
In January 2006, the Company introduced iLife '06, an upgrade to its consumer-oriented digital lifestyle application suite, which features iWeb™, iPhoto® 6, iMovie® HD 6, iDVD® 6, GarageBand™ 3, and iTunes® 6.0.2. All of these applications run natively on both Intel and PowerPC-based Macs (Universal).

iWeb™ is a new application in the iLife'06 suite. iWeb allows users to create online photo albums, blogs, and podcasts and customize websites using editing tools.

iPhoto® 6 adds new photo management and editing features, supports up to 250,000 photos, and introduces Photocasting™. Photocasting allows .Mac users to share and automatically update photo albums over the Internet with anyone who uses a Macintosh or Windows-based PC.

Source: APPLE COMPUTER INC, 10-Q, May 05, 2006

iMovie® HD 6 now includes new real-time effects that take advantage of Core Video technology, which uses the computer's video card's graphics processing unit to deliver hardware acceleration to quickly preview video effects. iMovie HD 6 also provides a solution to make video podcasts, which can be published with iWeb, and includes audio enhancement tools and sound effects.

iDVD® 6 now allows users to take content shot with HDV and widescreen DV cameras and author custom DVDs with widescreen menus, movies, and high resolution slideshows. iDVD 6 features 10 new Apple-designed menu themes in both widescreen (16:9) and standard (4:3) formats.

GarageBand™ 3 now allows users to record, produce, and publish through iWeb their own podcasts, including artwork, sound effects, and music jingles.

iWork™ '06
In January 2006, the Company introduced iWork '06, a new Universal version of the Company's suite of productivity software designed to help users create, present, and publish documents and presentations. iWork '06 includes Pages® 2 and Keynote™ 3.

Pages® 2 features mail merge with Mac OS® X Address Book, which allows users to personalize documents by dragging and dropping individual contacts into documents using templates with predefined fields. Pages 2 also features new templates for newsletters, flyers, posters, school reports, scrapbooks, brochures, business proposals, and invoices. Pages 2 allows users to insert tables that have basic calculation functionality within any document and users can export their Pages 2 document to other formats.

Keynote™ 3 offers additional ways to create presentations and interactive slideshows. It features new cinematic transitions including vertical and horizontal blinds, revolving door, and swoosh. A new view mode, Light Table, allows users to view an entire presentation and reorganize slides using drag and drop.

Final Cut Studio™ 5.1
In March 2006, the Company introduced Final Cut Studio 5.1, an update to the Company's High-Definition (HD) video production suite. Final Cut Studio 5.1 features Universal versions of Final Cut Pro 5, Soundtrack® Pro, Motion 2, and DVD Studio Pro 4.

Aperture™ 1.1
In April 2006, the Company introduced Aperture 1.1, an update to the Company's post production tool for photographers that is now a Universal application. Aperture 1.1 features RAW image rendering and a new set of advanced RAW adjustment controls.

Apple Remote Desktop™ 3
In April 2006, the Company introduced Apple Remote Desktop 3, the Company's third generation desktop management application. Apple Remote Desktop 3 is a Universal application for asset management and remote assistance, and features Spotlight searches across multiple Tiger systems, over 30 Automator actions for automating repetitive system administration tasks, a Dashboard Widget that provides observation of remote systems, and AutoInstall for installing software automatically on mobile systems when they return online.

Source: APPLE COMPUTER INC, 10-Q, May 05, 2006

Net Sales

The first six months of 2006 spanned 27 weeks while the first six months of 2005 spanned 26 weeks. This additional week is added to the first fiscal quarter approximately every six years to realign fiscal quarters with calendar quarters.

Net sales and Macintosh unit sales by operating segment and net sales and unit sales by product follow (net sales in millions and unit sales in thousands):

	Three Months Ended			Six Months Ended		
	4/1/06	3/26/05	Change	4/1/06	3/26/05	Change
Net Sales by Operating Segment:						
Americas net sales	$ 2,122	$ 1,443	47%	$ 4,822	$ 3,080	57%
Europe net sales	966	705	37%	2,208	1,552	42%
Japan net sales	309	284	9%	664	469	42%
Retail net sales	636	571	11%	1,708	1,132	51%
Other Segments net sales (a)	326	240	36%	706	500	41%
Total net sales	$ 4,359	$ 3,243	34%	$ 10,108	$ 6,733	50%
Unit Sales by Operating Segment:						
Americas Macintosh unit sales	494	477	4%	1,009	953	6%
Europe Macintosh unit sales	316	276	14%	703	596	18%
Japan Macintosh unit sales	82	102	−20%	163	166	−2%
Retail Macintosh unit sales	154	144	7%	347	263	32%
Other Segments Macintosh unit sales (a)	66	71	−7%	144	138	4%
Total Macintosh unit sales	1,112	1,070	4%	2,366	2,116	12%
Net Sales by Product:						
Desktops (b)	$ 833	$ 803	4%	$ 1,745	$ 1,804	−3%
Portables (c)	739	691	7%	1,551	1,295	20%
Total Macintosh net sales	1,572	1,494	5%	3,296	3,099	6%
iPod	1,714	1,014	69%	4,620	2,225	108%
Other music related products and services (d)	485	216	125%	976	393	148%
Peripherals and other hardware (e)	264	280	−6%	567	564	1%
Software, service, and other sales (f)	324	239	36%	649	452	44%
Total net sales	$ 4,359	$ 3,243	34%	$ 10,108	$ 6,733	50%
Unit Sales by Product:						
Desktops (b)	614	608	1%	1,281	1,231	4%
Portables (c)	498	462	8%	1,085	885	23%
Total Macintosh unit sales	1,112	1,070	4%	2,366	2,116	12%
Net sales per Macintosh unit sold (g)	$ 1,414	$ 1,396	1%	$ 1,393	$ 1,465	−5%
iPod unit sales	8,526	5,311	61%	22,569	9,891	128%
Net sales per iPod unit sold (h)	$ 201	$ 191	5%	$ 205	$ 225	−9%

Notes:

(a) Other Segments include Asia Pacific and FileMaker.
(b) Includes iMac, eMac, Mac mini, Power Mac, and Xserve product lines.
(c) Includes MacBook Pro, iBook, and PowerBook product lines.
(d) Consists of iTunes Music Store sales, iPod services, and Apple−branded and third−party iPod accessories.
(e) Includes Apple−branded and third−party displays, wireless connectivity and networking solutions, and other hardware accessories.
(f) Includes Apple−branded operating system software, application software, third−party software, AppleCare, and Internet services.
(g) Derived by dividing total Macintosh net sales by total Macintosh unit sales.
(h) Derived by dividing total iPod net sales by total iPod unit sales.

Source: APPLE COMPUTER INC, 10-Q, May 05, 2006

Net sales during the second quarter of 2006 increased 34% or $1.1 billion from the same period in 2005, and were up 50% or $3.4 billion for the first six months of 2006 compared to the same period in 2005. The increase for the six-month period was due in part to the fact that the first six months of 2006 spanned 27 weeks while the first six months of 2005 spanned 26 weeks. Several other factors contributed to these increases including the following:

- Net sales of iPods rose $700 million or 69% during the second quarter of 2006 and increased $2.4 billion or 108% in the first six months of 2006 compared to the same periods in 2005. Unit sales of iPods totaled 8.5 million in the second quarter of 2006, which represents an increase of 61% from the 5.3 million iPod units sold in the second quarter of 2005. For the first six months of 2006, iPod unit sales increased 128% to 22.6 million iPod units sold compared to 9.9 million iPod units sold in the same period in 2005. Strong sales of iPods during the second quarter and first six months of 2006 were driven by strong demand for the fifth generation iPod that was introduced in October 2005 and supports video, the iPod nano that was introduced in September 2005, and continued expansion of iPod points of distribution. Net sales per iPod unit sold increased by 5% year-over-year during the second quarter of 2006 due to a shift in product mix from the lower-priced iPod shuffle, which was first introduced in January 2005, towards the higher-priced fifth generation iPod. During the first six months of 2006, the net sales per iPod unit sold decreased by 9% compared to the first six months of 2005 primarily due to a shift in product mix towards the lower-priced iPod nano as well as price reductions on the iPod shuffle.

- Net sales of other music related products and services increased $269 million or 125% during the second quarter of 2006 and increased $583 million or 148% during the first six months of 2006 compared to the same periods in 2005. The increases were primarily due to increased net sales from the iTunes Music Store, iPod services and accessories, and the iPod Hi-Fi that was introduced in February 2006. The increase in sales from the iTunes Music Store relates to significant growth in U.S. sales and the expansion of the iTunes Music Store to 21 countries compared to 15 countries at March 26, 2005. The increased sales from the iTunes Music Store were also attributable to the introduction of video sales in October 2005. The Company has also experienced strong growth in sales of both Apple-branded and third-party iPod accessories and services, consistent with the increase in overall iPod unit sales for the second quarter and first six months of 2006.

- Net sales of software, service, and other sales rose $85 million or 36% during the second quarter of 2006 and rose $197 million or 44% during the first six months of 2006 compared to the same periods in 2005. This growth was primarily attributable to increased net sales of AppleCare Protection Plan (APP) extended service and support contracts, Mac OS X, Apple-branded and third-party application software, and Internet services.

- Macintosh net sales increased $78 million or 5% during the second quarter of 2006 and increased $197 million or 6% during the first six months of 2006 compared to the same periods in 2005. Macintosh unit sales increased by 42,000 units or 4% during the second quarter of 2006 and increased 250,000 units or 12% during the first six months of 2006 compared to the same periods in 2005. In January 2006, the Company announced the first two Macintosh computers running on Intel microprocessors, the iMac and MacBook Pro. The iMac began shipping immediately in January 2006 and the MacBook Pro began shipping in late February 2006, which limited the number of shipping weeks for the MacBook Pro during the second quarter of 2006. In February 2006, the Company announced and began shipping the new Mac mini that runs on the Intel microprocessor. The Company believes that the Intel transition has caused some customers to delay the purchase of new computers until the complete line of Intel-based Macintosh computers is introduced or until certain software applications are developed to run natively on Intel-based Macintosh computers. The increases in Macintosh net sales and unit sales were driven by higher sales of portable products in most of the Company's operating segments. Net sales and unit sales of the Company's portable products increased 7% and 8%, respectively, during the second quarter of 2006 compared to the same period in 2005, and increased 20% and 23% during the first six months of 2006 compared to the same period in 2005 due partially to strong initial demand of the MacBook Pro. Macintosh desktop net sales and unit sales increased by 4% and 1%, respectively, during the second quarter of 2006 compared to the same period in 2005 due to strong sales of the new Intel-based iMac, partially offset by a slight decrease in sales of the Company's professional-oriented desktop products. Macintosh desktop net sales decreased by 3% during the first six months of 2006, while Macintosh desktop unit sales increased by 4% during the first six months of 2006 compared to the same period in 2005. Net sales per Macintosh unit sold remained flat for

Source: APPLE COMPUTER INC, 10-Q, May 05, 2006

the second quarter of 2006 compared to the same period in 2005. Net sales per Macintosh unit sold decreased 5% for the first six months of 2006 compared to the same period in 2005 due to lower average selling prices on the iMac, iBook, and PowerBook.

- The Retail segment's net sales grew 11% to $636 million during the second quarter of 2006 and increased by 51% to $1.7 billion in the first half of 2006 compared to the same periods in 2005. Retail segment Macintosh unit sales increased 7% and 32%, respectively, during the second quarter and first six months of 2006 compared to the same periods in 2005. These increases are primarily attributable to an increase in total stores from 103 stores at the end of the second quarter of 2005 to 141 stores at the end of the second quarter of 2006, resulting in an average of 138 stores open during the quarter. During the second quarter of 2006, average revenue per store decreased to $4.6 million from $5.6 million in the second quarter of 2005. The Company believes the decrease in average revenue per store was primarily caused by the continued expansion of iPod points of distribution and a delay in purchases of Macintosh computers due to the Intel transition. With an average of 133 stores open during the first six months of 2006, average revenue per store increased to $12.8 million from $11.6 million in the first six months of 2005. This increase in average revenue per store was primarily due to strong sales of iPods, other music related products and services, and Macintosh portable products during the first quarter of 2006, partially offset by the slowdown in Macintosh sales during the second quarter of 2006.

- Net sales of peripherals and other hardware declined $16 million or 6% during the second quarter of 2006 compared to the second quarter of 2005 due to a decrease in net sales of displays partially offset by an increase in RAID storage and other hardware accessories including printers. During the first six months of 2006 net sales of peripherals and other hardware rose $3 million or 1% compared to the same period in 2005 due to an increase in net sales of RAID storage and other hardware accessories partially offset by a decrease in net sales of displays.

Segment Operating Performance

The Company manages its business primarily on a geographic basis. The Company's reportable operating segments are comprised of the Americas, Europe, Japan, and Retail. The Americas, Europe, and Japan reportable segments do not include activities related to the Retail segment. The Americas segment includes both North and South America. The Europe segment includes European countries as well as the Middle East and Africa. The Retail segment operates Apple–owned retail stores in the U.S., Canada, Japan, and the U.K. Each reportable geographic operating segment provides similar hardware and software products and similar services. Further information regarding the Company's operating segments may be found in Part I, Item 1 of this Form 10–Q in the Notes to Condensed Consolidated Financial Statements at Note 8, "Segment Information and Geographic Data."

Americas

Net sales in the Americas segment during the second quarter of 2006 increased $679 million or 47% compared to the same quarter in 2005, while Macintosh unit sales increased 4% year–over–year. The increase in net sales during the second quarter was primarily attributable to the significant growth in iPod sales, sales of other music related products and services, sales of desktop and portable Macintosh systems, and sales of APP. During the second quarter of 2006, the Americas segment represented approximately 49% of the Company's total net sales as compared to 44% in the same period of 2005.

For the first six months of 2006, net sales in the Americas segment increased $1.7 billion, or 57%, compared to the same period in 2005. The main driving factors for this increase were significant year–over–year increases in net sales of iPods, other music related products and services, portable Macintosh systems, and third–party software. This increase in net sales was partially offset by a decrease in desktop net sales. During the first six months of 2006, the Americas segment represented approximately 48% of the Company's total net sales as compared to 46% in the same period of 2005.

Europe

Net sales in Europe increased $261 million or 37% during the second quarter of 2006 compared to the same period in 2005. Total Macintosh unit sales in Europe were up 14% in the second quarter of 2006 compared to the same period in 2005. The Europe segment experienced strong sales of iPods, portable Macintosh systems, Internet services, Apple–branded software, and other music related products and services.

Source: APPLE COMPUTER INC, 10-Q, May 05, 2006

Europe segment net sales increased $656 million or 42% during the first six months of 2006 compared to the same period in 2005. Total Macintosh unit sales in Europe were up 18% in the first six months of 2006 compared to the same period in 2005. These increases were a result of strong growth in iPod sales, other music related products and services, and portable Macintosh systems. This segment also reported increased sales in APP, Apple-branded and third-party software, and Internet services, which was partially offset by a slight decrease in desktop net sales during the first half of 2006 compared to the same period in 2005.

Japan

Japan's net sales increased 9% or $25 million during the second quarter of 2006 compared to the same period in 2005. Japan experienced increased net sales in iPods, Apple-branded software, APP, and other music related products and services. These increases were partially offset by decreases in net sales of Macintosh desktop and portable systems and displays, and the weakening of the Yen. Total Macintosh unit sales decreased by 20% during the second quarter of 2006 compared to the same period in 2005. The Company believes the decrease was attributable to a pause in demand related to the Intel transition as customers wait for the new Intel-based Macintosh systems.

In the first six months of 2006, net sales in Japan segment increased $195 million or 42% compared to the same period in 2005. These increases were attributable to strong iPod sales, other music related products and services, Macintosh portable systems, and Mac OS X slightly offset by decreases in net sales of Macintosh desktop products.

Retail

During the second quarter of 2006, the Company opened 6 new retail stores. The Company had 141 retail stores open at the end of the second quarter of 2006 compared to 103 stores at the end of the second quarter of 2005. During the second quarter of 2006, the Retail segment's net sales grew to $636 million as compared to $571 million in the second quarter of 2005, an 11% increase. During the second quarter of 2006, average revenue per store decreased to $4.6 million from $5.6 million in the second quarter of 2005. Net sales for the first six months of 2006 grew to $1.7 billion from $1.1 billion during the same period in 2005, a 51% increase. During the first six months of 2006, average revenue per store increased to $12.8 million from $11.6 million in the first six months of 2005.

As measured by the Company's operating segment reporting, the Retail segment reported operating income of $29 million and $119 million during the second quarter and first six months of 2006, respectively, as compared to operating income of $42 million and $87 million during the second quarter and first six months of 2005, respectively. The decrease in profitability for the second quarter of 2006 was primarily due to the decline in average revenue per store.

Expansion of the Retail segment has required and will continue to require a substantial investment in fixed assets and related infrastructure, operating lease commitments, personnel, and other operating expenses. Capital expenditures associated with the Retail segment since its inception totaled $611 million through the end of the second quarter of 2006, of which $82 million was incurred during the first six months of 2006. As of April 1, 2006, the Retail segment had 4,851 full-time equivalent employees and had outstanding lease commitments associated with retail store space and related facilities of $782 million.

Gross Margin

Gross margin for the three and six-month periods ended April 1, 2006 and March 26, 2005 was as follows (in millions, except gross margin percentages):

	Three Months Ended		Six Months Ended	
	4/1/06	3/26/05	4/1/06	3/26/05
Net sales	$ 4,359	$ 3,243	$ 10,108	$ 6,733
Cost of sales	3,062	2,275	7,247	4,769
Gross margin	$ 1,297	$ 968	$ 2,861	$ 1,964
Gross margin percentage	29.8%	29.8%	28.3%	29.2%

Gross margin percentage remained flat at 29.8% for both the three-month periods ended April 1, 2006 and March 26, 2005. Favorable costs of certain commodity components including LCD flat-panel displays and NAND flash memory contributed to maintaining the gross margin percentage along with higher overall revenue that provided for more effective leverage on fixed production costs.

Source: APPLE COMPUTER INC, 10-Q, May 05, 2006

During the first six months of 2006, gross margin percentage decreased to 28.3% compared to 29.2% during the first six months of 2005. This was primarily due to a relative increase in sales of lower margin products in the first quarter of 2006, particularly the iPod product family and music-related services, partially offset by higher overall revenue that provided more effective leverage on fixed production costs. Additionally, gross margin on Macintosh net sales was lower on a year-over-year basis primarily due to reductions in average selling prices from the first six months of 2005.

The Company anticipates that its gross margin and the gross margin of the overall personal computer and consumer electronics industries will remain under pressure in light of price competition, especially for the iPod product line. The Company expects its gross margin percentage to decrease to about 28.5% in the third quarter of 2006 primarily as a result of a shift in the mix of revenue toward lower margin products as a result of the K-12 buying season, a full quarter impact of price reductions on the iPod shuffle and the introduction of the 1GB iPod nano, partially offset by favorable costs of certain commodity components including LCD flat-panel displays and NAND flash memory.

The foregoing statements regarding the Company's expected gross margin and forecasted revenue for the third quarter of 2006 are forward-looking. Gross margin could differ from anticipated levels because of several factors, including certain of those discussed in Part II, Item 1A. Risk Factors. There can be no assurance that current gross margins will be maintained, targeted gross margin levels will be achieved, or current margins on existing individual products will be maintained.

Operating Expenses

Operating expenses for the three and six-month periods ended April 1, 2006 and March 26, 2005 were as follows (in millions, except for percentages):

	Three Months Ended		Six Months Ended	
	4/1/06	3/26/05	4/1/06	3/26/05
Research and development	$ 176	$ 119	$ 358	$ 242
Percentage of net sales	4%	4%	4%	4%
Selling, general, and administrative expenses	$ 592	$ 447	$ 1,224	$ 917
Percentage of net sales	14%	14%	12%	14%

Research and Development (R&D)

Expenditures for R&D increased 48% or $57 million to $176 million in the second quarter of 2006 compared to $119 million in the second quarter of 2005, and increased 48% or $116 million to $358 million compared to the first six months of 2005. These increases were due primarily to an increase in R&D headcount in the current year to support expanded R&D activities, increases of $12 million and $25 million for the three and six-month periods ended April 1, 2006, respectively, in stock-based compensation expense resulting from the adoption of SFAS No. 123R and recognized as R&D expense, and higher overall expenses due to the 14th week added to the first fiscal quarter of 2006 to realign the Company's fiscal quarters with calendar quarters. In addition, during the second quarter and first six months of 2005, the Company capitalized approximately $14.7 million and $29.5 million, respectively of costs associated with the development of Mac OS X Tiger. No software development costs were capitalized during the second quarter or first six months of 2006. Despite the increase in expenditures, R&D as a percentage of net sales remained flat in both the second quarter and first six months of 2006 as compared to the same periods of 2005 due to the significant increase of 34% and 50% in total net sales for the Company in the second quarter and first six months of 2006, respectively. The Company continues to believe that focused investments in R&D are critical to its future growth and competitive position in the marketplace and are directly related to timely development of new and enhanced products that are central to the Company's core business strategy. As such, the Company expects to make further investments in R&D to remain competitive.

Selling, General, and Administrative Expense (SG&A)

Expenditures for SG&A increased $145 million or 32% and $307 million or 33%, respectively, for the three and six-month periods ended April 1, 2006, compared to the same periods in 2005. These increases were primarily due to higher direct and channel variable selling expenses resulting from the significant year-over-year increase in total net sales for the second quarter and first six months of 2006, the Company's continued expansion of its Retail segment in both domestic and international markets, increases of $16 million and $32 million for the three and six-month periods ended April 1, 2006, respectively, in stock-based compensation expense resulting from the adoption of SFAS

Source: APPLE COMPUTER INC, 10-Q, May 05, 2006

No. 123R and recognized as SG&A expense, a current year increase in discretionary spending on marketing and advertising, and the expenses associated with the 14th week added to the first fiscal quarter of 2006.

Other Income and Expense

Other income and expense for the three and six-month periods ended April 1, 2006 and March 26, 2005 were as follows (in millions):

	Three Months Ended		Six Months Ended	
	4/1/06	3/26/05	4/1/06	3/26/05
Interest income	$ 87	$ 39	$ 175	$ 67
Other income (expense), net	(11)	(6)	(18)	(8)
Other income and expense	$ 76	$ 33	$ 157	$ 59

Total other income and expense increased $43 million to $76 million during the second quarter of 2006 compared to $33 million in the second quarter of 2005, and increased $98 million to $157 million during the first six months of 2006 compared to $59 million in the first six months of 2005. These increases are attributable primarily to higher cash and short-term investment balances and increasing investment yields resulting from higher market interest rates, and the 14th week added to the first fiscal quarter of 2006. The weighted average interest rate earned by the Company on its cash, cash equivalents and short-term investments increased to 4.31% in the second quarter of 2006 compared to the 2.37% rate earned during the same period in 2005.

Provision for Income Taxes

The Company's effective tax rate for the three and six-months ended April 1, 2006 was approximately 32%, relatively consistent with the same periods in 2005. The Company's effective rate for both periods differs from the statutory federal income tax rate of 35% due primarily to certain undistributed foreign earnings for which no U.S. taxes are provided because such earnings are intended to be indefinitely reinvested outside the U.S.

The Internal Revenue Service (IRS) has completed its field audit of the Company's federal income tax returns for all years prior to 2002 and proposed certain adjustments. Certain of these adjustments are being contested through the IRS Appeals Office. Substantially all IRS audit issues for these years have been resolved. In addition, the Company is subject to audits by state, local, and foreign tax authorities. Management believes that adequate provision has been made for any adjustments that may result from tax examinations. However, the outcome of tax audits cannot be predicted with certainty. Should any issues addressed in the Company's tax audits be resolved in a manner not consistent with management's expectations, the Company could be required to adjust its provision for income tax in the period such resolution occurs.

On October 22, 2004, the American Jobs Creation Act (AJCA) was signed into law. The AJCA includes a provision for the deduction of 85% of certain foreign earnings that are repatriated, as defined in the AJCA. The Company may elect to apply this provision to repatriations of qualifying earnings in fiscal year 2006. The Company is continuing to evaluate the effects of the repatriation provision and expects to complete the evaluation in fiscal year 2006. A maximum of $755 million may be eligible for repatriation under the reduced tax rate provided by AJCA. However, given the uncertainties and complexities of the repatriation provision and the Company's continuing evaluation, the Company has not yet determined the amount that may be repatriated or the related potential income tax effects of such repatriation.

Recent Accounting Pronouncements

In December 2004, the Financial Accounting Standards Board (FASB) issued FASB Staff Position (FSP) 109-2, *Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision within the American Jobs Creation Act of 2004*. FSP 109-2 provides additional time to companies beyond the financial reporting period of enactment to evaluate the effects of the AJCA on their plans for repatriation of foreign earnings for purposes of applying SFAS No. 109, *Accounting for Income Taxes*. The Company is continuing to evaluate the repatriation provisions of AJCA, which if implemented by the Company would affect the Company's tax provision and deferred tax assets and liabilities. However, given the uncertainties and complexities of the repatriation provision and the Company's continuing evaluation, the Company has not yet determined the amount, if any, that will be repatriated or the related potential income tax effects of such repatriation. The Company expects to complete the evaluation in fiscal 2006.

Source: APPLE COMPUTER INC, 10-Q, May 05, 2006

In May 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections,* which replaces APB Opinion No. 20, *Accounting Changes* and SFAS No. 3, *Reporting Accounting Changes in Interim Financial Statements—An Amendment of APB Opinion No. 28.* SFAS No. 154 requires retrospective application to prior periods' financial statements of a voluntary change in accounting principal unless it is not practicable. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005 and is required to be adopted by the Company in the first quarter of fiscal 2007. Although the Company will continue to evaluate the application of SFAS No. 154, management does not currently believe adoption will have a material impact on the Company's results of operations or financial position.

Liquidity and Capital Resources

The following table presents selected financial information and statistics for each of the fiscal quarters ended on the dates indicated (dollars in millions):

	4/1/06	9/24/05
Cash, cash equivalents, and short-term investments	$ 8,226	$ 8,261
Accounts receivable, net	$ 861	$ 895
Inventory	$ 204	$ 165
Working capital	$ 6,830	$ 6,816
Days sales in accounts receivable (DSO) (a)	18	22
Days of supply in inventory (b)	6	6
Days payables outstanding (DPO) (c)	63	62
Operating cash flow (quarterly)	$ (125)	$ 752

(a) DSO is based on ending net trade receivables and most recent quarterly net sales for each period.
(b) Days supply of inventory is based on ending inventory and most recent quarterly cost of sales for each period.
(c) DPO is based on ending accounts payable and most recent quarterly cost of sales adjusted for the change in inventory.

As of April 1, 2006, the Company had $8.2 billion in cash, cash equivalents, and short-term investments, a decrease of $35 million over the same balances at the end of 2005. The principal components of this net decrease were repurchases of common stock of $353 million in conjunction with net-share settlements on vested restricted stock and restricted stock units and purchases of property, plant, and equipment of $275 million. These decreases were offset by proceeds from the issuance of common stock under stock plans of $212 million, tax benefits from stock option exercises of $283 million, and cash generated from operating activities of $158 million. Cash generated from operating activities includes the impact of the $1.25 billion prepayment for NAND flash memory components. The Company's short-term investment portfolio is primarily invested in high credit quality, liquid investments. Approximately $5 billion of this cash, cash equivalents, and short-term investments is held by the Company's foreign subsidiaries and would be subject to U.S. income taxation on repatriation to the U.S. The Company is currently assessing the impact of the one-time favorable foreign dividend provisions recently enacted as part of the AJCA, and may decide to repatriate earnings from some of its foreign subsidiaries.

The Company believes its existing balances of cash, cash equivalents, and short-term investments will be sufficient to satisfy its working capital needs, capital expenditures, stock repurchase activity, outstanding commitments, and other liquidity requirements associated with its existing operations over the next 12 months.

Capital Expenditures

The Company's total capital expenditures were $275 million during the first six months of 2006, $82 million of which were for retail store facilities and equipment related to the Company's Retail segment and $193 million of which were for corporate infrastructure, including information systems enhancements and operating facilities enhancements and expansions. The Company currently anticipates it will utilize approximately $700 million for capital expenditures during 2006, approximately $210 million of which is expected to be utilized for expansion of the Company's Retail segment, approximately $265 million of which is expected to be utilized for real estate acquisitions including the Company's second corporate campus and a new data center, and approximately $225 million of which is expected to be utilized to support normal replacement of existing capital assets and enhancements to general information technology infrastructure.

Source: APPLE COMPUTER INC, 10-Q, May 05, 2006

Stock Repurchase Plan
In July 1999, the Company's Board of Directors authorized a plan for the Company to repurchase up to $500 million of its common stock. This repurchase plan does not obligate the Company to acquire any specific number of shares or acquire shares over any specified period of time.

During the second quarter of 2006, the Company withheld a total of 4.6 million shares of its common stock at a price of $64.66 per share related to the net-share settlement upon vesting of restricted stock to pay the CEO's minimum statutory obligation for the applicable income and other employment taxes. This share withholding was not part of the Company's authorized stock repurchase plan. Other than this net-share settlement, the Company has not engaged in any transactions to repurchase its common stock since 2001. The Company has repurchased a total of 13.1 million shares at a cost of $217 million under this plan and was authorized to repurchase up to an additional $283 million of its common stock as of April 1, 2006.

Off-Balance Sheet Arrangements and Contractual Obligations
The Company has not entered into any transactions with unconsolidated entities whereby the Company has financial guarantees, subordinated retained interests, derivative instruments or other contingent arrangements that expose the Company to material continuing risks, contingent liabilities, or any other obligation under a variable interest in an unconsolidated entity that provides financing, liquidity, market risk or credit risk support to the Company.

Lease Commitments
As of September 24, 2005, the Company had total outstanding commitments on noncancelable operating leases of approximately $865 million, $606 million of which related to the lease of retail space and related facilities. The major facility leases are for terms of 5 to 15 years and generally provide renewal options for terms of 3 to 5 additional years. Leases for retail space are for terms of 5 to 20 years, the majority of which are for 10 years, and often contain multi-year renewal options. Total outstanding commitments on noncancelable operating leases related to the lease of retail space rose to $782 million as of April 1, 2006.

Purchase Commitments with Contract Manufacturers and Component Suppliers
The Company utilizes several contract manufacturers to manufacture sub-assemblies for the Company's products and to perform final assembly and test of finished products. These contract manufacturers acquire components and build product based on demand information supplied by the Company, which typically covers periods ranging from 30 to 150 days. The Company also obtains individual components for its products from a wide variety of individual suppliers. Consistent with industry practice, the Company acquires components through a combination of purchase orders, supplier contracts, and open orders based on projected demand information. Such purchase commitments typically cover the Company's forecasted component and manufacturing requirements for periods ranging from 30 to 150 days. As of April 1, 2006, the Company had outstanding third-party manufacturing commitments and component purchase commitments of approximately $1.3 billion.

During the first quarter of 2006, the Company entered into long-term supply agreements with Hynix Semiconductor, Inc., Intel Corporation, Micron Technology, Inc., Samsung Electronics Co., Ltd., and Toshiba Corporation to secure supply of NAND flash memory through calendar year 2010. As part of these agreements, the Company agreed to prepay $1.25 billion for flash memory components of which $750 million was paid during the first quarter of 2006 and the remaining $500 million was paid in the second quarter of 2006. These prepayments will be applied to inventory purchases made over the life of each respective agreement.

Asset Retirement Obligations
The Company's asset retirement obligations are associated with commitments to return property subject to operating leases to original condition upon lease termination. As of April 1, 2006, the Company estimated that gross expected future cash flows of approximately $18 million would be required to fulfill these obligations.

Other Obligations
The Company had other contractual obligations of approximately $45 million as of April 1, 2006 primarily related to telecommunications services contracts that were renewed in the first quarter of 2006 for a three-year period.

Indemnifications
The Company generally does not indemnify end-users of its operating system and application software against legal claims that the software infringes third-party intellectual property rights. Other agreements entered into by the Company sometimes include indemnification provisions under which the Company could be subject to costs and/or

Source: APPLE COMPUTER INC, 10-Q, May 05, 2006

damages in the event of an infringement claim against the Company or an indemnified third-party. However, the Company has not been required to make any significant payments resulting from such an infringement claim asserted against it or an indemnified third-party and, in the opinion of management, does not have a liability related to unresolved infringement claims subject to indemnification that would have a material adverse effect on its financial condition, liquidity or results of operations.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

The Company's market risk profile has not changed significantly from that described in the 2005 Form 10-K.

Interest Rate and Foreign Currency Risk Management
The Company regularly reviews its foreign exchange forward and option positions and its interest rate swap and option positions, both on a stand-alone basis and in conjunction with its underlying foreign currency and interest rate related exposures. However, given the effective horizons of the Company's risk management activities and the anticipatory nature of the exposures, there can be no assurance the hedges will offset more than a portion of the financial impact resulting from movements in either foreign exchange or interest rates. In addition, the timing of the accounting for recognition of gains and losses related to mark-to-market instruments for any given period may not coincide with the timing of gains and losses related to the underlying economic exposures and, therefore, may adversely affect the Company's operating results and financial position.

Interest Rate Risk
While the Company is exposed to interest rate fluctuations in many of the world's leading industrialized countries, the Company's interest income and expense is most sensitive to fluctuations in the general level of U.S. interest rates. In this regard, changes in U.S. interest rates affect the interest earned on the Company's cash, cash equivalents, and short-term investments as well as costs associated with foreign currency hedges.

The Company's short-term investment policy and strategy is to ensure the preservation of capital, meet liquidity requirements, and optimize return in light of the current credit and interest rate environment. The Company benchmarks its performance by utilizing external money managers to manage a small portion of the aggregate investment portfolio. The external managers adhere to the Company's investment policies and also provide occasional research and market information that supplements internal research used to make credit decisions in the investment process.

The Company's exposure to market risk for changes in interest rates relates primarily to the Company's investment portfolio. The Company places its short-term investments in highly liquid securities issued by high credit quality issuers and, by policy, limits the amount of credit exposure to any one issuer. The Company's general policy is to limit the risk of principal loss and ensure the safety of invested funds by limiting market and credit risk. All highly liquid investments with maturities of three months or less are classified as cash equivalents; highly liquid investments with maturities greater than three months are classified as short-term investments. As of April 1, 2006, approximately $76 million of the Company's short-term investments had underlying maturities ranging from 1 to 5 years. The remainder all had underlying maturities between 3 and 12 months. The Company may sell its investments prior to their stated maturities for strategic purposes, in anticipation of credit deterioration, or for duration management. The Company recognized no material net gains or losses during the first six months of 2006 or 2005 related to such sales.

Foreign Currency Risk
In general, the Company is a net receiver of currencies other than the U.S. dollar. Accordingly, changes in exchange rates, and in particular a strengthening of the U.S. dollar, may negatively affect the Company's net sales and gross margins as expressed in U.S. dollars. There is also a risk that the Company will have to adjust local currency product pricing due to competitive pressures when there has been significant volatility in foreign currency exchange rates.

The Company may enter into foreign currency forward and option contracts with financial institutions to protect against foreign exchange risks associated with existing assets and liabilities, certain firmly committed transactions, forecasted future cash flows, and net investments in foreign subsidiaries. Generally, the Company's practice is to hedge a majority of its existing material foreign exchange transaction exposures. However, the Company may not hedge certain foreign exchange transaction exposures due to immateriality, prohibitive economic cost of hedging particular exposures, and limited availability of appropriate hedging instruments.

Source: APPLE COMPUTER INC, 10-Q, May 05, 2006

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures
Based on an evaluation under the supervision and with the participation of the Company's management, the Company's principal executive officer and principal financial officer have concluded that the Company's disclosure controls and procedures as defined in rules 13a–15(e) and 15d–15(e) under the Securities Exchange Act of 1934, as amended (Exchange Act) were effective as of April 1, 2006 to ensure that information required to be disclosed by the Company in reports that it files or submits under the Exchange Act is (i) recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission rules and forms and (ii) accumulated and communicated to the Company's management, including its principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

Changes in Internal Control Over Financial Reporting
There were no significant changes in the Company's internal control over financial reporting identified in management's evaluation during the second quarter of 2006 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

The Company is subject to various legal proceedings and claims that are discussed below. The Company is also subject to certain other legal proceedings and claims that have arisen in the ordinary course of business and which have not been fully adjudicated. In the opinion of management, the Company does not have a potential liability related to any current legal proceedings and claims that would individually or in the aggregate have a material adverse effect on its financial condition, liquidity or results of operations. However, the results of legal proceedings cannot be predicted with certainty. Should the Company fail to prevail in any of these legal matters or should several of these legal matters be resolved against the Company in the same reporting period, the operating results of a particular reporting period could be materially adversely affected. The Company settled certain matters during the second quarter of 2006 that did not individually or in the aggregate have a material impact on the Company's results of operations.

Allen v. Apple Computer, Inc.
On January 28, 2005 a plaintiff filed a purported nationwide class action in Los Angeles Superior Court alleging that a defect in the Company's 17–inch Studio Display monitors results in dimming of half of the screen and constant blinking of the power light. Plaintiff filed an amended complaint on October 24, 2005, adding additional named plaintiffs and expanding the alleged class to include purchasers of the 20–inch Apple Cinema Display and the 23–inch Apple Cinema HD Display. The amended complaint alleges that the displays have a purported defect that causes dimming of one–half of the screen, and that the Company misrepresented the quality of the displays and/or concealed the purported defect. Plaintiffs assert claims under California Business & Professions Code §17200 (unfair competition); California Business & Professions Code §17500 (false advertising) and the Consumer Legal Remedies Act. The amended complaint seeks remedies including damages and equitable relief. On November 14, 2005, the Company filed an answer to the amended complaint as to the allegations regarding the 17–inch display and a demurrer/motion to strike as to the allegations regarding the 20–inch and 23–inch displays on the ground that plaintiffs failed to allege that they purchased those displays. At a status conference on November 1, 2005, the Court ordered Plaintiffs to amend their complaint. Plaintiff filed an amended complaint on December 12, 2005, and the Company answered on January 5, 2006 denying all allegations and asserting numerous affirmative defenses. The case is in discovery.

Apple Computer, Inc. v. Burst.com, Inc.
The Company filed an action for declaratory judgment against Defendant Burst.com, Inc. on January 4, 2006. The Company seeks declaratory judgment that U.S. Patent Nos. 4,963,995, 5,164,839, and 5,995,705 are invalid and not infringed by the Company. Burst filed an answer and counter claim on April 17, 2006. Burst alleges that the following Apple products infringe U.S. Patent Nos. 4,963,995, 5,057,932, 5,164,839, and 5,995,705: iTunes Music Store, iPod devices, QuickTime products, iTunes software and Apple computers and servers running iTunes software or QuickTime. The patents allegedly relate to methods and devices used for "burst" transmission of audio or video files.

Source: APPLE COMPUTER INC, 10-Q, May 05, 2006

Apple Corps Ltd. v. Apple Computer, Inc.; Apple Computer, Inc. v. Apple Corps Ltd.
Plaintiff Apple Corps filed this action on July 4, 2003 in the High Court of Justice, Chancery Division, in London alleging that the Company has breached a 1991 agreement that resolved earlier trademark litigation between the parties regarding use of certain Apple marks. Plaintiff seeks an injunction, unspecified damages, and other relief. The Company filed a motion on October 13, 2003, challenging jurisdiction in the U.K. The Court denied this motion on April 7, 2004. The Company filed an appeal of the Court's decision but subsequently withdrew the appeal. In November 2004, Plaintiff served the Company with an Amended Bill of Particulars and on December 23, 2004, the Company filed a Defence. On November 24, 2005, Plaintiff filed a Re-Amended Bill of Particulars and the Company filed its Defence on December 16, 2005. Trial took place from March 29, 2006 through April 5, 2006. The parties await a ruling.

On October 8, 2003, the Company filed a lawsuit against Apple Corps in the United States District Court for the Northern District of California requesting a declaratory judgment that the Company has not breached the 1991 agreement. Apple Corps challenged jurisdiction in the California case but the Court denied that challenge on March 25, 2004. Apple Corps subsequently prevailed on a motion to stay the California case during the pendency of the U.K. action. The Company has dismissed the California lawsuit without prejudice.

Bader v. Anderson; Bader v. Apple Computer, Inc. et al.
Plaintiff filed this purported shareholder derivative action against the Company and each of its current executive officers and members of its Board of Directors on May 19, 2005 in Santa Clara County Superior Court asserting claims for breach of fiduciary duty, material misstatements and omissions, and violations of California Businesses and Professions Code §17200 (unfair competition). Plaintiff alleges that the Company's March 14, 2005, proxy statement was false and misleading for failure to disclose certain information relating to the Apple Computer, Inc. Performance Bonus Plan, which was approved by shareholders at the annual meeting held on April 21, 2005. Plaintiff, who ostensibly brings suit on the Company's behalf, has made no demand on the Board of Directors and alleges that such demand is excused. Plaintiff seeks injunctive and other relief for purported injury to the Company. On July 27, 2005, Plaintiff filed an amended complaint alleging that, in addition to the purported derivative claims, adoption of the bonus plan and distribution of the proxy statement describing that plan also inflicted injury on her directly as an individual shareholder. On January 10, 2006, the Court sustained defendants' demurrer to the amended complaint, with leave to amend. Plaintiff filed a second amended complaint on February 7, 2006. The Company filed a demurrer to that complaint on April 20, 2006 and a hearing is scheduled for June 13, 2006.

Baghdasarian, et al. v. Apple Computer, Inc.
Plaintiffs filed this action in Los Angeles County Superior Court on October 31, 2005, on behalf of a purported nationwide class of all purchasers of all Apple wireless products (router, modem, or adaptor) sold at any time. The complaint alleges that the Company misrepresented the transmission rates of these products. The complaint alleges causes of action for breach of express warranty and for violations of the Consumer Legal Remedies Act, California Business & Professions Code §17200 (unfair competition) and California Business & Professions Code §17500 (false advertising). The complaint seeks damages and equitable remedies. The Company filed an answer denying all allegations and asserting numerous affirmative defenses to the complaint on December 15, 2005.

Birdsong v. Apple Computer, Inc.; Patterson v. Apple Computer, Inc.
These federal court complaints allege that the Company's iPod music players, and the ear bud headphones sold with them, are inherently defective in design and are sold without adequate warnings concerning the risk of noise-induced hearing loss by iPod users. The Birdsong action was initially filed on January 30, 2006 in the United States Antitrust Court for the Western District of Louisiana on behalf of a purported Louisiana class of iPod purchasers and alleges violations of the Louisiana Products Liability Act, breaches of implied warranties, unjust enrichment and negligent misrepresentation. The Patterson action was filed on January 31, 2006 in the United States Antitrust Court for the Northern District of California on behalf of a purported class of all iPod purchasers within the four-year period before January 31, 2006. That action alleges breaches of implied and express warranties, violations of California Business & Professions Code §17200 (unfair competition), California Business & Professions Code §17500 (false advertising), the Consumer Legal Remedies Act, breaches of express and implied warranties, negligent misrepresentation and unjust enrichment. The Birdsong action has been transferred to the Northern District of California and assigned to the same judge as in Patterson. The Company's responses to the Birdsong and Patterson complaints are not yet due.

Source: APPLE COMPUTER INC, 10-Q, May 05, 2006

A similar complaint, *Royer–Brennan v. Apple Computer, Inc. and Apple Canada, Inc.*, was filed in Montreal, Quebec, Canada, on February 1, 2006, seeking authorization to institute a class action on behalf of iPod purchasers in Quebec. Preliminary motions must be filed by May 5, 2006.

Branning et al. v. Apple Computer, Inc.
Plaintiffs originally filed this purported class action in San Francisco County Superior Court on February 17, 2005. The initial complaint alleged violations of California Business & Professions Code §17200 (unfair competition) and violation of the Consumer Legal Remedies Act (CLRA) regarding a variety of purportedly unfair and unlawful conduct including, but not limited to, allegedly selling used computers as new and failing to honor warranties. Plaintiffs also brought causes of action for misappropriation of trade secrets, breach of contract, and violation of the Song–Beverly Act. Plaintiffs requested unspecified damages and other relief. On May 9, 2005, the Court granted the Company's motion to transfer the case to Santa Clara County Superior Court. On May 2, 2005, Plaintiffs filed an amended complaint adding two new named plaintiffs and three new causes of action including a claim for treble damages under the Cartwright Act (California Business & Professions Code §16700 et seq.) and a claim for false advertising. The Company filed a demurrer to the amended complaint, which the Court sustained in its entirety on November 10, 2005. The Court granted Plaintiffs leave to amend and they filed an amended complaint on December 29, 2005. Plaintiffs' amended complaint added three plaintiffs and alleged many of the same factual claims as the previous complaints, such as alleged selling of used equipment as new, alleged failure to honor warranties and service contracts for the consumer plaintiffs, and alleged fraud related to the opening of the Apple Retail stores. Plaintiffs continued to assert causes of action for unfair competition (§17200), violations of the CLRA, breach of contract, misappropriation of trade secrets, violations of the Cartwright Act and alleged new causes of action for fraud, conversion and breach of the implied covenant of good faith and fair dealing. The Company filed a demurrer to the amended complaint on January 31, 2006, which the Court sustained on March 3, 2006 on sixteen of seventeen causes of action.

Butzer, et al. v. Apple Computer, Inc.; Wirges v. Apple Computer, Inc.; Blackwell v. Apple Computer, Inc.
Plaintiffs filed the Butzer action on August 23, 2005, in the United States District Court for the Northern District of California, San Jose Division, on behalf of a purported nationwide class of all purchasers of the Company's PowerBook G4 portable computers. The complaint alleges defects in the memory of the computers. The complaint alleges that this purported defect extends to other series of the Company's portables and states that plaintiffs reserve the right to amend the complaint to include these other series. Plaintiffs assert claims for alleged violations of California Business & Professions Code §17200 (unfair competition), California Business & Professions Code §17500 (false advertising), the Consumer Legal Remedies Act (CLRA) and the Song–Beverly Consumer Warranty Act. The complaint seeks remedies including restitution and/or damages and injunctive relief. The Wirges action was filed on January 20, 2006 in the United States District Court for the Eastern District of Arkansas, also on behalf of a purported nationwide class, and makes similar allegations. Plaintiffs assert claims for breach of warranties, violation of the Magnuson–Moss Act, strict products liability and unjust enrichment. The complaint seeks restitution, damages and other remedies. The Blackwell action was filed on February 10, 2006, on behalf of a purported nationwide class, and makes identical allegations to those made in the Butzer case. Plaintiffs assert claims for breach of express and implied warranties, violation of the California CLRA, violation of the California Song–Beverly Act, false advertising and unfair competition. The complaint seeks restitution, an injunction and other remedies. The Company filed an answer to the Butzer complaint on October 19, 2005 denying all material allegations and asserting numerous affirmative defenses. The case is in discovery. The Company filed an answer to the Wirges action on February 28, 2006. The Company has filed a motion to transfer the Wirges case to the Northern District of California. The Company filed an answer to the Blackwell complaint on March 15, 2006 denying all material allegations and asserting numerous affirmative defenses.

Compression Labs, Inc. v. Apple Computer, Inc., et al.; Apple v. Compression Labs, Inc., et al.
Plaintiff Compression Labs, Inc. filed this patent infringement action on April 22, 2004 against the Company and twenty–seven other defendants in the United States District Court for the Eastern District of Texas, Marshall Division, alleging infringement of U.S. patent 4,698,672 (the '672 patent). Plaintiff alleges that the Company infringes the patent by complying with the JPEG standard as defined by CCITT Recommendation T.81 entitled "Information Technology—Digital Compression and Coding of Continuous Tone Still Images—Requirements and Guidelines." Plaintiff seeks unspecified damages and other relief.

On July 2, 2004, the Company and several other defendants in the Texas action filed a lawsuit in the United States District Court in Delaware against Compression Labs, Inc. and two other companies, requesting a declaratory

Source: APPLE COMPUTER INC, 10-Q, May 05, 2006

judgment of non-infringement, invalidity, implied license and unenforceability with respect to the '672 patent. Additional actions regarding this patent have been filed in other jurisdictions. On February 16, 2005, the Panel on Multi-District Litigation (MDL) granted a petition filed by certain defendants seeking coordination and transfer of all of these cases to one court for pre-trial proceedings. The MDL Panel has transferred all of the cases to the Northern District of California. The defendants in the Texas and Delaware actions had filed motions to dismiss prior to the transfer and both motions are still pending. A Markman hearing took place on March 9, 2006 and the parties await a ruling.

Contois Music Technology LLC v. Apple Computer, Inc.
Plaintiff Contois Music Technology ("Contois") filed this action on June 13, 2005 in the United States District Court for Vermont, alleging infringement by the Company of U.S. Patent No. 5,864,868, entitled "Computer Control System and User Interface for Media Playing Devices." The complaint, which was served on October 4, 2005, seeks unspecified damages and other relief. The Company filed an answer on November 23, 2005 denying all material allegations and asserting numerous affirmative defenses. A Markman hearing is scheduled for June 13, 2006.

Two similar complaints relative to iPod battery life, *Wolfe v. Apple* and *Hirst v. Apple,* were filed in Toronto, Ontario, Canada on August 15, 2005 and September 12, 2005, respectively. Both actions define the purported class as a national class consisting of all persons in Canada who have purchased or who own an iPod. In addition, a similar complaint regarding iPod battery life, *Hamiliton v. Apple Computer, Inc.* and *Apple Canada, Inc.* was filed in Calgary, Alberta, Canada on October 5, 2005, purportedly on behalf of all purchasers of iPods in Alberta, Canada. That complaint has not been served. A motion for certification is set for June 9, 2006.

Davis v. Apple Computer, Inc.
Plaintiff filed this purported class action in San Francisco County Superior Court on December 5, 2002, alleging that the Company engaged in unfair and deceptive business practices relating to its AppleCare Extended Service and Warranty Plan. Plaintiff asserts causes of action for violation of California Business & Professions Code §17200 (unfair competition), California Business & Professions Code §17500 (false advertising), breach of the Song-Beverly Warranty Act, intentional misrepresentation and concealment. Plaintiff requests unspecified damages and other relief. The Company filed a demurrer and motion to strike which were granted, in part, and Plaintiff filed an amended complaint. The Company filed an answer on April 17, 2003 denying all allegations and asserting numerous affirmative defenses. Plaintiff subsequently amended his complaint. On October 29, 2003, the Company filed a motion to disqualify Plaintiff's counsel in his role as counsel to the purported class and to the general public. The Court granted the motion but allowed Plaintiff to retain substitute counsel. Plaintiff did engage new counsel for the general public, but not for the class. The Company moved to disqualify Plaintiff's new counsel and to have the Court dismiss the general public claims for equitable relief. The Court declined to disqualify Plaintiff's new counsel or to dismiss the equitable claims, but did confirm that the class action claims are dismissed. The Company appealed the ruling and the case was stayed pending the outcome of the appeal. The Court of Appeals denied the appeal on August 17, 2005, affirming the trial court's decision. The Company filed a Petition for review with the California Supreme Court, which was denied on November 23, 2005. The case has been remanded back to the trial court.

European Commission Investigation
The European Commission has notified the Company that it is investigating certain matters relating to the iTunes Music Store in the European Union (EU). The European Commission is investigating claims made by Which?, a United Kingdom (UK) consumer association, that the Company is violating EU competition law by charging more for online music in the UK than in Eurozone countries and preventing UK consumers from purchasing online music from the iTunes Music Store for Eurozone countries. The Which? claims were originally lodged with the UK Office of Fair Trading, which subsequently referred them to the European Commission. The European Commission is investigating the charges under Articles 81 and 82 of the European Commission Treaty.

Gillis et al. v. Apple Computer, Inc.
Plaintiffs filed this purported class action on December 23, 2005 in San Diego County Superior Court alleging that the Company has misrepresented the hard drive capacity of two Powerbook G4 computers: the 12 inch, 1.5 GHz computer with 512 MB of memory and a 100GB hard drive; and the 15 inch, 1.67 GHz computer with 1GB of memory and a 100GB hard drive. Plaintiffs allege that the Company's standard disclosure on its packaging regarding hard drive size was not present on the packaging for these two models. The complaint alleges violations of the California Business & Profession Code §17200 (unfair competition), California Business & Profession Code §17500 (false advertising), the Consumer Legal Remedies Act, and causes of action for deceit and negligent

Source: APPLE COMPUTER INC, 10-Q, May 05, 2006

misrepresentation. Plaintiffs seek restitution and other relief. On February 28, 2006, the Company filed a demurrer and a motion to strike. The Company withdrew the demurrer and motion to strike per stipulations and await an amended complaint.

Goldberg, et al. v. Apple Computer, Inc., et al. (f.k.a. "Dan v. Apple Computer, Inc.")
Plaintiffs filed this purported class action on September 22, 2003 in Los Angeles County Superior Court against the Company and other members of the computer industry on behalf of an alleged nationwide class of purchasers of certain computer hard drives. The case alleges violations of California Business and Professions Code §17200 (unfair competition), the Consumer Legal Remedies Act and false advertising related to the size of the drives. Plaintiffs allege that calculation of hard drive size using the decimal method misrepresents the actual size of the drive. The complaint seeks restitution and other relief. Plaintiffs filed an amended complaint on March 30, 2004 and the Company filed an answer on September 23, 2004, denying all allegations and asserting numerous affirmative defenses. Defendants filed a motion to strike portions of the complaint based on sales by resellers and filed a motion for judgment on the pleadings based upon Proposition 64. The Court granted both motions at a hearing on April 6, 2005. Plaintiffs thereafter filed an amended complaint on May 6, 2005. The Defendants filed a demurrer on June 6, 2005, which was heard on August 22, 2005. The Court granted the demurrer in part and denied it in part. Plaintiffs filed an amended complaint and the Company filed an answer on December 15, 2005 denying all allegations and asserting numerous assertive defenses.

Honeywell International, Inc., et al. v. Apple Computer, Inc., et al.
Plaintiffs Honeywell International, Inc. and Honeywell Intellectual Properties, Inc. filed this action on October 6, 2004 in the United States District Court in Delaware alleging infringement by the Company and other defendants of U.S. patent 5,280,371 entitled "Directional Diffuser for a Liquid Crystal Display." Plaintiffs seek unspecified damages and other relief. The Company filed an answer on December 21, 2004 denying all material allegations and asserting numerous affirmative defenses. The Company has tendered the case to several LCD manufacturer suppliers. On May 18, 2005 the Court stayed the case against the Company and the other non-manufacturer defendants. Plaintiffs filed an amended complaint on November 7, 2005 adding additional defendants and expanding the scope of the accused products. Given the stay, the Company's response to the amended complaint is not yet due.

Lenzi v. Apple Canada, Inc. (filed June 7, 2005, Superior Court, Montreal, Quebec)
Plaintiff filed a purported class action allegedly on behalf of Quebec customers claiming false advertising and breach of warranty relating to iPod battery life. Plaintiff sought authorization to institute a class action on behalf of Generations 1, 2 and 3 iPod owners in Quebec. On February 2, 2006, the Court dismissed Plaintiff's motion for authorization to institute a class action. Plaintiff has appealed this ruling.

MacTech Systems v. Apple Computer, Inc.; Macadam v. Apple Computer, Inc.; Computer International, Inc. v. Apple Computer, Inc.; Elite Computers and Software, Inc. v. Apple Computer, Inc.; The Neighborhood Computer Store v. Apple Computer, Inc.; MacAccessory Center, Inc. v. Apple Computer, Inc.; Creative Online Computer Services, Inc., DBA MacOnline v. Apple Computer, Inc.; MacGuys, Inc. v. Apple Computer, Inc. (all in Santa Clara County Superior Court)
Eight resellers filed similar lawsuits against the Company between late 2002 and early 2006 for various causes of action including breach of contract, fraud, negligent and intentional interference with economic relationship, negligent misrepresentation, trade libel, unfair competition and false advertising. Plaintiffs request unspecified damages and other relief. The Company answered the Computer International complaint on November 12, 2003, denying all allegations and asserting numerous affirmative defenses. The Company filed an answer in the Macadam case on December 3, 2004 denying all allegations and asserting numerous defenses. Three of the other Plaintiffs filed amended complaints on February 7, 2005, and on March 16, 2005 the Company filed answers to these claims denying all allegations and asserting numerous affirmative defenses. A sixth Plaintiff, MacAccessory Center, filed a complaint on February 23, 2005. The Company filed an answer to this complaint on April 20, 2005 denying all allegations and asserting numerous affirmative defenses. On February 28, 2006, MacGuys and Creative Online filed complaints against the Company. The Company's responses to these complaints are not yet due. All of these cases with the exception of Macadam are in discovery and are coordinated (along with the Branning class action) in Santa Clara Superior Court. The cases (except Branning, MacGuys and Creative Online) are set for trial on November 27, 2006. On December 19, 2005, Tom Santos, Macadam's principal and an original Plaintiff in the Macadam case, filed a Fifth Amended Complaint on his own behalf (not on behalf of Macadam) alleging fraud, violations of California Business & Professional Code §17200 (unfair competition), California Business & Professional Code

Source: APPLE COMPUTER INC, 10-Q, May 05, 2006

§17500 (false advertising) and the Consumer Legal Remedies Act. The Company filed a demurrer to Santos' amended complaint and a special motion to strike the defamation cause of action on January 20, 2006. Those motions were heard on February 17, 2006, and the Court sustained the demurrer without leave to amend as to one cause of action, overruled the demurrer as to one cause of action and sustained the demurrer with leave to amend as to two causes of action. The Court also denied the special motion to strike. Santos has not yet filed a further amended complaint. The Company also filed a cross complaint against Santos on January 20, 2006 alleging violations of California Business & Professional Code §17200, fraud and deceit, breach of contract, and violation of California Penal Code §502.

On October 1, 2003, one of the reseller Plaintiffs, Macadam, was deauthorized as an Apple reseller. Macadam filed a motion for a temporary order to reinstate it as a reseller, which the Court denied. The Court denied Macadam's motion for a preliminary injunction on December 19, 2003. On December 6, 2004 Macadam filed for Chapter 11 Bankruptcy in the Northern District of California, which placed a stay on the litigation as to Macadam only. The Company filed a claim in the bankruptcy proceedings on February 16, 2005. The Macadam bankruptcy case was converted to Chapter 7 (liquidation) on April 29, 2005. The Company has reached a tentative settlement of the Macadam case with the Chapter 7 Bankruptcy Trustee. The Bankruptcy Court denied, without prejudice, the Trustee's motion to approve that settlement on April 7, 2006. We expect the Trustee to re–file the motion to approve the settlement with further support.

Macsolutions Inc. v. Apple Computer, Inc.
Plaintiff Macsolutions, Inc., an Apple authorized reseller, filed this lawsuit against the Company on January 20, 2006 alleging breach of contract, fraud, misappropriation of trade secrets, intentional interference with economic advantage, violation of the Cartwright Act, violation of California Business & Professions Code §17200 (unfair business practices) and fraudulent concealment. The factual allegations in this complaint are similar to those in the eight other reseller cases and the Branning class action. Principally, Plaintiffs allege that the Company has treated Macsolutions unfairly compared to other resellers, that the Company has competed unfairly in opening the Apple Retail stores, and has allegedly sold used goods as new. The Company's response is not yet due.

Premier International Associates LLC v. Apple Computer, Inc.
Plaintiff Premier International Associates LLC filed this action on November 3, 2005 in the United States District Court for the Eastern District of Texas, Marshall Division, alleging infringement by the Company of U.S. Patents 6,243,725 and 6,763,345 both entitled "List Building System." The complaint seeks unspecified damages and other relief. The Company filed an answer on January 13, 2006 denying all material allegations and asserting numerous affirmative defenses. The Company also asserted counter claims for a declaratory judgment of noninfringement and invalidity.

Quantum Technology Management, Ltd. v. Apple Computer, Inc.
Plaintiff filed this action on December 21, 2005 in the United States Court for the District of Maryland against the Company and Fingerworks Ltd., alleging infringement of U.S. Patent number 5,730,165 entitled "Time Domain Capacitive Field Detector." The complaint seeks unspecified damages and other relief. The Company's response is not yet due.

Slattery v. Apple Computer, Inc.
Plaintiff filed this purported class action on January 3, 2005 in the United States District Court for the Northern District of California alleging various claims including alleged unlawful tying of music purchased on the iTunes Music Store with the purchase of iPods and vice versa and unlawful acquisition or maintenance of monopoly market power. Plaintiff's complaint alleged violations of §§1 and 2 of the Sherman Act (15 U.S.C. §§1 and 2), California Business and Professions Code §16700 et seq. (the Cartwright Act), California Business and Professions Code §17200 (unfair competition), common law unjust enrichment and common law monopolization. Plaintiff seeks unspecified damages and other relief. The Company filed a motion to dismiss on February 10, 2005. On September 9, 2005, the Court denied the motion in part and granted it in part. Plaintiff filed an amended complaint on September 23, 2005 and the Company filed an answer on October 18, 2005. On May 8, 2006, the Court will hear Plaintiff's motion for leave to file a second amended complaint that substitutes two new plaintiffs for Slattery.

St–Germain v. Apple Canada, Inc.
Plaintiff filed this case in Montreal, Quebec, Canada, on August 5, 2005, seeking authorization to institute a class action for the refund by the Company of the Canadian Private Copying Levy that was applied to the iPod purchase

Source: APPLE COMPUTER INC, 10-Q, May 05, 2006

price in Quebec between December 12, 2003 and December 14, 2004 but later declared invalid by the Canadian Court. The Company has completed a refund program for this levy. A class certification hearing took place January 13, 2006. On February 24, 2006 the Court granted class certification and notice was published during the last week of March 2006.

Teleshuttle Technologies, LLC and BTG International Inc. v. Microsoft Corporation and Apple Computer, Inc.
Plaintiffs filed this case on July 20, 2004 in United States District Court for the Northern District of California alleging infringement of U.S. patent 6,557,054, entitled "Method and System for Distributing Updates by Presenting Directory of Software Available for User Installation That is Not Already Installed on User Station." Plaintiffs filed an amended complaint on September 7, 2004, adding a second patent, U.S. patent 6,769,009 entitled "Method and System for Selecting a Personalized Set of Information Channels." Plaintiffs seek unspecified damages and other relief. The Company filed an answer on October 18, 2004, denying all material allegations and asserting numerous affirmative defenses. On August 22, 2005, the Company filed an amended answer to add charges of inequitable conduct. The parties reached a settlement and on April 7, 2006, the Court entered an order dismissing the complaint. The matter is now concluded. Settlement of this matter did not have a material effect on the Company's financial position or results of operations.

Tse v. Apple Computer, Inc. et al.
Plaintiff Ho Keung Tse filed this action against the Company and other defendants on August 5, 2005 in the United States District Court for the District of Maryland alleging infringement by the Company of U.S. Patent 6,665,797 entitled "Protection of Software Again [sic] Against Unauthorized Use." The complaint seeks unspecified damages and other relief. The Company filed an answer on October 31, 2005 denying all material allegations and asserting numerous affirmative defenses. On October 28, 2005, the Company and the other defendants filed a motion to transfer the case to the Northern District of California.

Union Federale des Consummateurs – Que Choisir v. Apple Computer France S.A.R.L. and iTunes S.A.R.L.
Plaintiff, a consumer association in France, filed this complaint on February 9, 2005 alleging that the above–listed entities are violating consumer law by (1) omitting to mention that the iPod is allegedly not compatible with music from online music services other than the iTunes Music Store and that the music from the iTunes Music Store is only compatible with the iPod and (2) allegedly tying the sales of iPods to the iTunes Music Store and vice versa. Plaintiff seeks damages, injunctive relief and other relief. The first hearing on the case took place on May 24, 2005. The Company's response to the complaint was served on November 8, 2005. Plaintiff's responsive pleading was filed on February 10, 2006. The Company's reply submission is not yet due.

Wimmer v. Apple Computer, Inc. (originally filed as *Tomczak v. Apple Computer, Inc.* on October 19, 2005 in the United States District Court for the Northern District of California, San Jose Division; amended complaint filed October 26, 2005); *Moschella, et al., v. Apple Computer, Inc.* (filed October 26, 2005 United States District Court for the Northern District of California, San Jose Division); *Calado, et al. v. Apple Computer, Inc.* (filed October 26, 2005, Los Angeles County Superior Court); *Kahan, et al., v. Apple Computer, Inc.* (filed October 31, 2005, United States District Court for the Southern District of New York); *Jennings, et al., v. Apple Computer, Inc.* (filed November 4, 2005, United States District Court for the Northern District of California, San Jose Division); *Rappel v. Apple Computer, Inc.* (filed on November 23, 2005, United States District Court for the District of New Jersey); *Mayo v. Apple Computer, Inc.* (filed on December 7, 2005, United States District Court for the Middle District of Louisiana); *Valencia v. Apple Computer, Inc.* (filed on December 22, 2005, United States District Court for the Northern District of California); *Williamson v. Apple Computer, Inc.* (filed on December 29, 2005, United States District Court for the Middle District of Louisiana); *Sioson v. Apple Computer, Inc.* (filed on February 9, 2006, San Mateo County Superior Court; First Amended Complaint filed March 16, 2006) These federal and state court complaints allege that the Company's iPod nano was defectively designed so that it scratches excessively during normal use, rendering the screen unreadable. The Wimmer and Moschella actions were brought on behalf of purported nationwide classes of iPod nano purchasers, with the exception of California purchasers, and allege violations of the consumer protection, express and implied warranty statutes of each state covered by the putative class definition, as well as negligent misrepresentation and unjust enrichment under the common laws of these jurisdictions. The Calado action was brought on behalf of a purported California class of iPod nano purchasers and asserts claims for alleged violation of California Business & Professions Code §17200 (unfair competition), California Business & Professions Code §17500 (false advertising), the Consumer Legal Remedies Act (CLRA), breaches of express and implied warranties, negligent misrepresentation and unjust enrichment. The Jennings action was brought on behalf of a purported class of all iPod nano purchasers outside of the United States,

Source: APPLE COMPUTER INC, 10-Q, May 05, 2006

based upon alleged violations of the same California statutes as in the Calado complaint. The Kahan action was brought on behalf of a purported New York class of iPod nano purchasers and alleges claims under the New York unfair competition law, breach of express warranty and unjust enrichment. The Rappel complaint is filed on behalf of a purported New Jersey class of purchasers and alleges claims under the New Jersey Consumer Fraud Acts and for breach of warranty and unjust enrichment. The Mayo and Williamson complaints were both brought on behalf of a Louisiana class of purchasers, and allege breach of warranties, unjust enrichment and violations of the Louisiana Products Liability Act. The Valencia complaint was brought on behalf of a worldwide class of purchasers and alleges breach of warranties, fraudulent concealment, violations of California's Business & Professions Code §17200 and §17500 and the CLRA, negligent misrepresentation and unjust enrichment. The complaints seek damages and various other remedies. The Sioson complaint was brought on behalf of a purported class of California purchasers. The complaint alleges breach of express and implied warranties, unjust enrichment, fraudulent concealment, and violation of California Business & Professions Code §17200 (unfair competition), California Business & Professions Code § 17500 (false advertising), the CLRA; it purports to seek relief based upon alleged scratching and screen cracking. The Company filed a motion for transfer and consolidation before Judicial Panel on Multi-District Litigation (MDL) to have all of the federal cases transferred to the Northern District of California and consolidated for pre-trial purposes. In an order dated April 17, 2006, the MDL Panel granted the Company's motion and transferred the federal cases to the Northern District of California before the Honorable Ronald M. Whyte. The federal cases are all stayed pending further order by Judge Whyte following the MDL Panel's order, and accordingly the responses to the federal complaints are not yet due. The Company's response to the Calado complaint is not yet due. The case is stayed pending a ruling on the petition for coordination with the Sioson action. The Court has recommended coordination of these two cases in Los Angeles Superior Court.

Two similar complaints, *Carpentier v. Apple Canada, Inc.*, and *Royer-Brennan v. Apple Computer, Inc. and Apple Canada, Inc.* were filed in Montreal, Quebec, Canada, on October 27, 2005 and November 9, 2005, respectively, seeking authorization to institute class actions on behalf of iPod nano purchasers in Quebec. A similar complaint, *Mund v. Apple Canada Inc. and Apple Computer, Inc.*, was filed in Ontario, Canada on January 9, 2006 seeking authorization to institute a class action on behalf of iPod nano purchasers in Canada. In the two Quebec Class Actions, a motion to stay the Royer-Brennan suit for lis pendens was heard by the Court on April 21, 2006. The parties await a decision.

Item 1A. Risk Factors

Because of the following factors, as well as other factors affecting the Company's operating results and financial condition, past financial performance should not be considered to be a reliable indicator of future performance, and investors should not use historical trends to anticipate results or trends in future periods.

General economic conditions and current economic and political uncertainty could adversely affect the demand for the Company's products and the financial health of its suppliers, distributors, and resellers.
The Company's operating performance depends significantly on general economic conditions in the U.S. and abroad. At times in the past, demand for the Company's products has been negatively impacted by difficult global economic conditions. Additionally, some of the Company's education customers appeared to be delaying technology purchases due to concerns about the overall impact of the weaker economy and state budget deficits on their available funding. Although recent macroeconomic trends seem to indicate an economic recovery, continued uncertainty about future economic conditions makes it difficult to forecast future demand for the Company's products and related operating results. Should global and/or regional economic conditions deteriorate, demand for the Company's products could be adversely affected, as could the financial health of its suppliers, distributors, and resellers.

War, terrorism, public health issues or other business interruptions could disrupt supply, delivery or demand of products, which could negatively affect the Company's operations and performance.
War, terrorism, public health issues and other business interruptions whether in the U.S. or abroad, have caused and could cause damage or disruption to international commerce by creating economic and political uncertainties that may have a strong negative impact on the global economy, the Company, and the Company's suppliers or customers. The Company's major business operations are subject to interruption by earthquake, other natural disasters, fire, power shortages, terrorist attacks and other hostile acts, labor disputes, public health issues, and other events beyond its control. The majority of the Company's research and development activities, its corporate headquarters, information technology systems, and other critical business operations, including certain component suppliers and manufacturing vendors, are located near major seismic faults. Because the Company does not carry earthquake

Source: APPLE COMPUTER INC, 10-Q, May 05, 2006

insurance for direct quake–related losses, the Company's operating results and financial condition could be materially adversely affected in the event of a major earthquake or other natural or manmade disaster.

Although it is impossible to predict the occurrences or consequences of any such events, such events could result in a decrease in demand for the Company's products, make it difficult or impossible for the Company to deliver products to its customers or to receive components from its suppliers, and could create delays and inefficiencies in the Company's supply chain. In addition, should major public health issues, including pandemics, arise, the Company could be negatively impacted by the need for more stringent employee travel restrictions, additional limitations in the availability of freight services, governmental actions limiting the movement of products between various regions, delays in production ramps of new products, and disruptions in the operations of the Company's manufacturing vendors and component suppliers. The Company's operating results and financial condition have been, and in the future may be, adversely affected by these events.

The market for personal computers and related peripherals and services, as well as digital music devices and related services, is highly competitive. If the Company is unable to effectively compete in these markets, its results of operations could be adversely affected.

The personal computer industry is highly competitive and is characterized by aggressive pricing practices, downward pressure on gross margins, frequent introduction of new products, short product life cycles, evolving industry standards, continual improvement in product price/performance characteristics, rapid adoption of technological and product advancements by competitors, price sensitivity on the part of consumers, and a large number of competitors. Over the past several years, price competition in the market for personal computers and related peripherals has been particularly intense as competitors who sell Windows and Linux based personal computers have aggressively cut prices and lowered their product margins for personal computing products. The Company's results of operations and financial condition have been, and in the future may continue to be, adversely affected by these and other industry–wide pricing pressures and downward pressures on gross margins.

The personal computer industry has also been characterized by rapid technological advances in software functionality, hardware performance, and features based on existing or emerging industry standards. Further, as the personal computer industry and its customers place more reliance on the Internet, an increasing number of Internet devices that are smaller and simpler than traditional personal computers may compete for market share with the Company's existing products. Several competitors of the Company have either targeted or announced their intention to target certain of the Company's key market segments, including consumer, education, professional and consumer digital video editing, and design and publishing. Several of the Company's competitors have introduced or announced plans to introduce digital music products and/or online stores offering digital music distribution that mimic many of the unique design, technical features, and solutions of the Company's products. The Company has a significant number of competitors, many of whom have greater financial, marketing, manufacturing, and technological resources, as well as broader product lines and larger installed customer bases than those of the Company. Additionally, there has been a trend towards consolidation in the personal computer industry that has resulted in larger and potentially stronger competitors in the Company's markets.

The Company is currently the only maker of hardware using the Mac OS. The Mac OS has a minority market share in the personal computer market, which is dominated by makers of computers utilizing other competing operating systems, including Windows and Linux. The Company's future operating results and financial condition are substantially dependent on its ability to continue to develop improvements to the Macintosh platform to maintain perceived design and functional advantages over competing platforms. Additionally, if unauthorized copies of the Mac OS are used on other companies' hardware products and result in decreased demand for the Company's hardware products, the Company's results of operations may be adversely affected.

The Company is currently focused on market opportunities related to digital music distribution and related consumer electronic devices, including iPods. The Company faces increasing competition from other companies promoting their own digital music products, including music enabled cell phones, distribution services, and free peer–to–peer music services. These competitors include both new entrants with different market approaches, such as subscription services models, and also larger companies that may have greater technical, marketing, distribution, and other resources than those of the Company, as well as established hardware, software, and digital content supplier relationships. In addition, certain countries have proposed or may propose in the future new legislation that would cause suppliers of technical protection measures to provide information so that content may be played on any system, which could have an impact on the Company's ability to offer new and innovative products in a timely manner.

Source: APPLE COMPUTER INC, 10-Q, May 05, 2006

Failure to effectively compete could negatively affect the Company's operating results and financial position. There can be no assurance that the Company will be able to continue to provide products and services that effectively compete in these markets or successfully distribute and sell digital content outside the U.S. The Company may also have to respond to price competition by lowering prices and/or increasing features which could adversely affect the Company's music product gross margins as well as overall Company gross margins.

The Company also faces increased competition in the U.S. education market. U.S. elementary and secondary schools, as well as college and university customers, remain a core market for the Company. Uncertainty in this channel remains as several competitors of the Company have either targeted or announced their intention to target the education market for personal computers, which could negatively affect the Company's market share. In an effort to regain market share and remain competitive, the Company has been and will continue to pursue one-to-one (1:1) learning solutions in education. 1:1 learning solutions typically consist of iBook portable systems for every student and teacher along with a wireless network connected to a central server. These 1:1 learning solutions and other strategic sales are generally priced more aggressively and could result in significantly less profitability or even in financial losses, particularly for larger deals. Although the Company believes it has taken certain steps to strengthen its position in the education market, there can be no assurance that the Company will be able to increase or maintain its share of the education market or execute profitably on large strategic arrangements. Failure to do so may have an adverse impact on the Company's operating results and financial condition.

The Company's transition from PowerPC microprocessors used by Macintosh computers to microprocessors built by Intel is subject to numerous risks.
In June 2005, the Company announced its intention to transition from the use of PowerPC microprocessors to the use of Intel microprocessors in all of its Macintosh computers by the end of calendar year 2007. As of April 1, 2006, the Company has introduced the new iMac®, MacBook Pro™, and Mac® mini computers, which run on Intel microprocessors. The Company now expects to complete this transition by the end of calendar year 2006. This transition is subject to numerous risks and uncertainties, including the Company's ability to timely develop and deliver new products using Intel microprocessors, the timely innovation and delivery of related hardware and software products, including the Company's applications, to support Intel microprocessors, market acceptance of Intel-based Macintosh computers, the development and availability on acceptable terms of components and services essential to enable the Company to timely deliver Intel-based Macintosh computers, and the effective management of inventory levels in line with anticipated product demand for both PowerPC and Intel-based Macintosh computers. In addition, the Company is dependent on third-party software developers such as Microsoft and Adobe continuing to support current applications that run on PowerPC-based computers and timely developing versions of current and future applications that run on Intel and PowerPC-based Macintosh computers. Microsoft and Adobe have announced that their Universal versions of Microsoft Office and Creative Suite applications, respectively, may not be available until calendar year 2007. The Company's inability to timely deliver new Intel-based products or obtain developer commitment both to continue supporting applications that run on PowerPC microprocessors and timely transition their applications to run natively on Intel-based products may have an adverse impact on the Company's results of operations. The Company's ongoing transition to Intel microprocessors has negatively impacted and may continue to negatively impact sales of current and future Macintosh products containing PowerPC microprocessors, as customers may elect to delay purchases until the Intel-based products are available. Additionally, there can be no assurance that the Company will be able to maintain its historical gross margin percentages on its products, including Intel-based Macintosh computers, which may adversely impact the Company's results of operations.

Future operating results are dependent upon the Company's ability to obtain a sufficient supply of components, including microprocessors, some of which are in short supply or available only from limited sources.
Although most components essential to the Company's business are generally available from multiple sources, certain key components including microprocessors and ASICs are currently obtained by the Company from single or limited sources. Some key components (including without limitation DRAM, NAND flash-memory, and TFT-LCD flat-panel displays), while currently available to the Company from multiple sources, are at times subject to industry-wide availability and pricing pressures. In addition, new products introduced by the Company often initially utilize custom components obtained from only one source until the Company has evaluated whether there is a need for, and subsequently qualifies additional suppliers. In situations where a component or product utilizes new technologies, initial capacity constraints may exist until such time as the suppliers' yields have matured. The Company and other producers in the personal computer industry also compete for various components with other industries that have experienced increased demand for their products. The Company uses some components that are not common to the rest of the personal computer industry including certain microprocessors and ASICs. Continued availability of these

Source: APPLE COMPUTER INC, 10-Q, May 05, 2006

components may be affected if producers decided to concentrate on the production of components other than those customized to meet the Company's requirements. If the supply of a key component were delayed or constrained on a new or existing product, the Company's results of operations and financial condition could be adversely affected.

The Company's ability to produce and market competitive products is dependent on the ability and desire of IBM and Freescale Semiconductor, Inc. (Freescale) to supply PowerPC G4 and G5 microprocessors and Intel to supply its microprocessors for the Company's Macintosh computers and to provide the Company with a sufficient supply of microprocessors with price/performance features that compare favorably to those supplied to the Company's competitors. While the Company has supply agreements with IBM and Freescale, the Company's recent announcement of plans to transition to Intel microprocessors may impact the continued availability on acceptable terms of certain components and services, including PowerPC G4 and G5 microprocessors, which are essential to the Company's business and are currently obtained by the Company from sole or limited sources. Additionally, there have been instances in recent years where the inability of the Company's suppliers to provide advanced PowerPC microprocessors in sufficient quantity has had significant adverse effects on the Company's results of operations. In addition, IBM is currently the Company's sole supplier of the PowerPC G5 processor, which is used in the Company's current Power Mac and Xserve products. Freescale is the sole supplier of the PowerPC G4 processor, which is used in the Company's eMac, and iBook products. Manufacturing problems experienced by any of the Company's suppliers in the future or failure by them to deliver components to the Company in sufficient quantities with competitive price/performance features could adversely affect the Company's results of operations and financial condition.

The Company must successfully manage frequent product introductions and transitions to remain competitive and effectively stimulate customer demand.
Due to the highly volatile and competitive nature of the personal computer and consumer electronics industries, which are characterized by dynamic customer demand patterns and rapid technological advances, the Company must continually introduce new products and technologies, enhance existing products to remain competitive, and effectively stimulate customer demand for new products and upgraded versions of the Company's existing products. The success of new product introductions is dependent on a number of factors, including market acceptance; the Company's ability to manage the risks associated with product transitions, including the transition to Intel-based Macintosh computers, and production ramp issues; the availability of application software for new products; the effective management of purchase commitments and inventory levels in line with anticipated product demand, including anticipated demand for PowerPC-based and Intel-based Macintosh computers; the availability of products in appropriate quantities to meet anticipated demand; and the risk that new products may have quality or other defects in the early stages of introduction. Accordingly, the Company cannot determine in advance the ultimate effect that new products will have on its sales or results of operations.

The Company's products from time to time experience quality problems that can result in decreased net sales and operating profits.
The Company sells highly complex hardware and software products that can contain defects in design and manufacture. Sophisticated operating system software and applications, such as those sold by the Company, often contain "bugs" that can unexpectedly interfere with the operation of the software. Defects may also occur in components and products the Company purchases from third-parties. There can be no assurance that the Company will be able to detect and fix all defects in the hardware and software it sells. Failure to do so could result in lost revenue, loss of reputation, and significant warranty and other expense to remedy.

Because orders for components, and in some cases commitments to purchase components, must be placed in advance of customer orders, the Company faces substantial inventory risk.
The Company records a write-down for inventories of components and products that have become obsolete or are in excess of anticipated demand or net realizable value and accrues necessary reserves for cancellation fees of orders for inventories that have been cancelled. Although the Company believes its inventory and related provisions are currently adequate, given the rapid and unpredictable pace of product obsolescence in the computer and consumer electronics industries and the transition to Intel-based Macintosh computers, no assurance can be given that the Company will not incur additional inventory and related charges. In addition, such charges have had, and may have, a material effect on the Company's financial position and results of operations.

The Company must order components for its products and build inventory in advance of product shipments. Because the Company's markets are volatile and subject to rapid technology and price changes, and because of the transition

Source: APPLE COMPUTER INC, 10-Q, May 05, 2006

to Intel-based Macintosh computers, there is a risk the Company will forecast incorrectly and produce or order from third parties excess or insufficient inventories of particular products. Consistent with industry practice, components are normally acquired through a combination of purchase orders, supplier contracts, and open orders based on projected demand information. Such purchase commitments typically cover the Company's forecasted component and manufacturing requirements for periods ranging from 30 to 150 days. The Company's operating results and financial condition have been in the past and may in the future be materially adversely affected by the Company's ability to manage its inventory levels and respond to short-term shifts in customer demand patterns.

The Company is dependent on manufacturing and logistics services provided by third parties, many of whom are located outside of the U.S.

Most of the Company's products are manufactured in whole or in part by third-party manufacturers. In addition, the Company has outsourced much of its transportation and logistics management. While outsourcing arrangements may lower the cost of operations, they also reduce the Company's direct control over production and distribution. It is uncertain what effect such diminished control will have on the quality or quantity of the products manufactured or services rendered, or the flexibility of the Company to respond to changing market conditions. Moreover, although arrangements with such manufacturers may contain provisions for warranty expense reimbursement, the Company may remain at least initially responsible to the consumer for warranty service in the event of product defects. Any unanticipated product defect or warranty liability, whether pursuant to arrangements with contract manufacturers or otherwise, could adversely affect the Company's future operating results and financial condition.

Final assembly of products sold by the Company is currently performed in the Company's manufacturing facility in Cork, Ireland, and by external vendors in Fremont, California, Fullerton, California, Taiwan, the Republic of Korea, the People's Republic of China, and the Czech Republic. Currently, manufacturing of many of the components used in the Company's products is performed by third-party vendors in Taiwan, China, Japan, Korea, and Singapore. Final assembly of substantially all of the Company's portable products including MacBook Pro, iBooks, and iPods is performed by third-party vendors in China. If for any reason manufacturing or logistics in any of these locations is disrupted by regional economic, business, labor, environmental, public health, or political issues, or due to information technology system failures or military actions, the Company's results of operations and financial condition could be adversely affected.

The Company's future operating performance is dependent on the performance of distributors and other resellers of the Company's products.

The Company distributes its products through wholesalers, resellers, national and regional retailers, and cataloguers, many of whom distribute products from competing manufacturers. In addition, the Company sells many of its products and resells certain third-party products in most of its major markets directly to end users, certain education customers, and certain resellers through its online stores around the world and its retail stores. Many of the Company's resellers operate on narrow product margins and have been negatively affected by weak economic conditions over the last several years. Considerable trade receivables that are not covered by collateral or credit insurance are outstanding with the Company's distribution and retail channel partners. The Company's business and financial results could be adversely affected if the financial condition of these resellers weakens, if resellers within consumer channels were to cease distribution of the Company's products, or if uncertainty regarding demand for the Company's products caused resellers to reduce their ordering and marketing of the Company's products. The Company has invested and will continue to invest in various programs to enhance reseller sales, including staffing selected resellers' stores with Company employees and contractors. These programs could require a substantial investment from the Company, while providing no assurance of return or incremental revenue to offset this investment.

Over the past several years, an increasing proportion of the Company's net sales have been made by the Company directly to end-users through its online stores around the world and through its retail stores in the U.S., Canada, Japan, and the U.K. Some of the Company's resellers have perceived this expansion of the Company's direct sales as conflicting with their own businesses and economic interests as distributors and resellers of the Company's products. Perception of such a conflict could discourage the Company's resellers from investing additional resources in the distribution and sale of the Company's products or lead them to limit or cease distribution of the Company's products. The Company's business and financial results could be adversely affected if expansion of its direct sales to end-users causes some or all of its resellers to cease or limit distribution of the Company's products.

Source: APPLE COMPUTER INC, 10-Q, May 05, 2006

Further information regarding risks associated with Marketing and Distribution may be found in Part I, Item 1 of the 2005 Form 10-K for the year ended September 24, 2005 under the heading "Markets and Distribution."

The Company relies on third-party digital content, which may not be available to the Company on commercially reasonable terms or at all.

The Company contracts with third parties to offer their digital content to customers through the Company's iTunes Music Store. The Company pays substantial fees to obtain the rights to offer to its customers this third-party digital content. The Company's licensing arrangements with these third-party content providers are short-term in nature and do not guarantee the future renewal of these arrangements at commercially reasonable terms, if at all. Certain parties in the music industry have consolidated and formed alliances, which could limit the availability and increase the fees required to offer digital content to customers through the iTunes Music Store. Further, some third-party content providers currently, or may in the future, offer music products and services that compete with the Company's music products and services, and could take action to make it more difficult or impossible for the Company to license their digital content in the future. If the Company is unable to continue to offer a wide variety of digital content at reasonable prices with acceptable usage rules, or continue to expand its geographic reach outside the U.S., then sales and gross margins of the Company's iTunes Music Store, as well as related hardware and peripherals, including iPods, may be adversely affected.

Third-party content providers and artists require that the Company provide certain digital rights management solutions and other security mechanisms. If the requirements from content providers or artists change, then the Company may be required to further develop or license technology to address such new rights and requirements. In addition, certain countries have proposed or may propose in the future new legislation that would cause suppliers of technical protection measures to provide information so that content may be played on any system, which could lessen the protection of content subjecting it to piracy and could affect arrangements with the Company's content suppliers. There is no assurance that the Company will be able to develop or license such solutions at a reasonable cost and in a timely manner, if at all, which could have a materially adverse effect on the Company's operating results and financial position.

The Company's future performance is dependent upon support from third-party software developers. If third-party software applications cease to be developed or available for the Company's hardware products, then customers may choose not to buy the Company's products.

The Company believes that decisions by customers to purchase the Company's personal computers, as opposed to Windows-based systems, are often based on the availability of third-party software for particular applications such as Microsoft Office. The Company also believes the availability of third-party application software for the Company's hardware products depends in part on third-party developers' perception and analysis of the relative benefits of developing, maintaining, and upgrading such software for the Company's products versus software for the larger Windows market or growing Linux market. This analysis may be based on factors such as the perceived strength of the Company and its products, the anticipated potential revenue that may be generated, continued acceptance by customers of Mac OS X, and the costs of developing such software products. To the extent the minority market share held by the Company in the personal computer market has caused software developers to question the Company's prospects in the personal computer market, developers could be less inclined to develop new application software or upgrade existing software for the Company's products and more inclined to devote their resources to developing and upgrading software for the larger Windows market or growing Linux market. The Company's recent announcement that it plans to add a feature to the next version of Mac OS X that will enable Intel-based Macs to run Windows XP may deter developers from creating software applications for Mac OS X if such applications are available for the Windows platform. Moreover, there can be no assurance software developers will continue to develop software for Mac OS X, the Company's operating system, on a timely basis or at all.

In June 2005, the Company announced its plan to begin using Intel microprocessors in its Macintosh computers and as of April 1, 2006, the Company had introduced the new iMac®, MacBook™ Pro, and Mac® mini computers, which run on Intel microprocessors. The Company expects to complete this transition to Intel microprocessors for all of its Macintosh computers by the end of calendar year 2006. The Company depends on third-party software developers to timely develop current and future applications that run on Intel and PowerPC microprocessors. Microsoft and Adobe have announced that their Universal versions of Microsoft Office and Creative Suite applications, respectively, may not be available until calendar year 2007. The Company's inability to timely deliver new Intel-based products, or a decline in available applications that run on the Company's PowerPC products or the lack of applications that run on Intel-based Macintosh systems could have a materially adverse effect on the Company's operating results and financial position.

Source: APPLE COMPUTER INC, 10-Q, May 05, 2006

In addition, past and future development by the Company of its own software applications and solutions may negatively impact the decision of software developers, such as Microsoft and Adobe, to develop, maintain, and upgrade similar or competitive software for the Company's products. The Company currently markets and sells a variety of software applications for use by professionals, consumers, and education customers that could influence the decisions of third-party software developers to develop or upgrade Macintosh-compatible software products. Software applications currently marketed by the Company include software for professional film and video editing, professional compositing and visual effects for large format film and video productions, professional music production and music post production, professional and consumer DVD encoding and authoring, professional digital photo editing and workflow management, consumer digital video and digital photo editing and management, digital music management, desktop-based database management, word processing, and high-quality presentations. The Company also markets an integrated productivity application that incorporates word processing, page layout, image manipulation, spreadsheets, databases, and presentations in a single application. Discontinuance of third-party products for the Macintosh platform could have an adverse effect on the Company's net sales and results of operations.

The Company's business relies on access to patents and intellectual property obtained from third parties, and the Company's future results could be adversely affected if it is alleged or found to have infringed on the intellectual property rights of others.
Many of the Company's products are designed to include intellectual property obtained from third parties. While it may be necessary in the future to seek or renew licenses relating to various aspects of its products and business methods, the Company believes that based upon past experience and industry practice, such licenses generally could be obtained on commercially reasonable terms. However, there can be no assurance that the necessary licenses would be available or available on acceptable terms.

Because of technological changes in the computer and consumer electronics industries, current extensive patent coverage, and the rapid rate of issuance of new patents, it is possible certain components of the Company's products and business methods may unknowingly infringe existing patents of others. The Company has from time to time been notified that it may be infringing certain patents or other intellectual property rights of others. Responding to such claims, regardless of their merit, can be time-consuming, result in significant expenses, and cause the diversion of management and technical personnel. Several pending claims are in various stages of evaluation. The Company may consider the desirability of entering into licensing agreements in certain of these cases. However, no assurance can be given that such licenses can be obtained on acceptable terms or that litigation will not occur. In the event there is a temporary or permanent injunction entered prohibiting the Company from marketing or selling certain of its products or a successful claim of infringement against the Company requiring it to pay royalties to a third-party, the Company's future operating results and financial condition could be adversely affected. Information regarding certain claims and litigation involving the Company related to alleged patent infringement and other matters is set forth in Part II, Item 1 of this Form 10-Q and Part I, Item 3 of the 2005 Form 10-K. In the opinion of management, the Company does not have a potential liability for damages or royalties from any current legal proceedings or claims related to the infringement of patent or other intellectual property rights of others that would individually or in the aggregate have a material adverse effect on its results of operations, or financial condition. However, the results of such legal proceedings cannot be predicted with certainty. Should the Company fail to prevail in any of the matters related to infringement of patent or other intellectual property rights of others described in Part II, Item 1 of this Form 10-Q or should several of these matters be resolved against the Company in the same reporting period, the operating results of a particular reporting period could be materially adversely affected.

The Company's retail initiative has required and will continue to require a substantial investment and commitment of resources and is subject to numerous risks and uncertainties.
Through April 30, 2006, the Company had opened 142 retail stores. The Company's retail initiative has required substantial investment in equipment and leasehold improvements, information systems, inventory, and personnel. The Company has also entered into substantial operating lease commitments for retail space with lease terms ranging from 5 to 20 years, the majority of which are for 10 years. The Company could incur substantial costs should it choose to terminate this initiative or close individual stores. Such costs could adversely affect the Company's results of operations and financial condition. Additionally, a relatively high proportion of the Retail segment's costs are fixed because of depreciation on store construction costs and lease expense. As a result, significant losses would result should the Retail segment experience a significant decline in sales for any reason.

Source: APPLE COMPUTER INC, 10-Q, May 05, 2006

Certain of the Company's stores have been designed and built to serve as high profile venues that function as vehicles for general corporate marketing, corporate events, and brand awareness. Because of their unique design elements, locations and size, these stores require substantially more investment in equipment and leasehold improvements than the Company's more typical retail stores. The Company has opened seven such stores through April 2006. Because of their location and size, these high profile stores also require the Company to enter into substantially larger operating lease commitments compared to those required for its more typical stores. Current leases on such locations have terms ranging from 10 to 14 years with total remaining commitments per location ranging from $4 million to $48 million. Closure or poor performance of one of these high profile stores could have a particularly significant negative impact on the Company's results of operations and financial condition.

Many of the general risks and uncertainties the Company faces could also have an adverse impact on its Retail segment. Also, many factors unique to retail operations present risks and uncertainties, some of which are beyond the Company's control, that could adversely affect the Retail segment's future results, cause its actual results to differ from those currently expected, and/or have an adverse effect on the Company's consolidated results of operations. Potential risks and uncertainties unique to retail operations that could have an adverse impact on the Retail segment include, among other things, macro-economic factors that have a negative impact on general retail activity; inability to manage costs associated with store construction and operation; failure to attract new users to the Macintosh platform; inability to sell third-party hardware and software products at adequate margins; failure to manage relationships with existing retail channel partners; lack of experience in managing retail operations outside the U.S.; costs associated with unanticipated fluctuations in the value of Apple-branded and third-party retail inventory; and inability to obtain quality retail locations at reasonable cost.

Investment in new business strategies and initiatives could disrupt the Company's ongoing business and may present risks not originally contemplated.
The Company has and may in the future invest in new business strategies or engage in acquisitions that complement the Company's strategic direction and product roadmap. Such endeavors may involve significant risks and uncertainties, including distraction of management's attention away from normal business operations; insufficient revenue generation to offset liabilities assumed and expenses associated with the strategy; and unidentified issues not discovered in the Company's due diligence process. Because these new ventures are inherently risky, no assurance can be given that such strategies and initiatives will be successful and will not materially adversely affect the Company's business, operating results or financial condition.

Declines in the sales of the Company's professional products, software, accessories, or service and support contracts, or increases in sales of consumer products, including iPods, may negatively impact the Company's gross margin and operating margin percentages.
The Company's professional products, including MacBook Pro and Power Mac systems, software, accessories, and service and support contracts, generally have higher gross margins than the Company's consumer products, including the iMac, Mac mini, iBook, iPod, and content from the iTunes Music Store. A shift in sales mix away from higher margin professional products towards lower margin consumer products could adversely affect the Company's future gross margin and operating margin percentages. The Company's traditional professional customers may choose to buy consumer products, specifically the iMac and iBook, instead of professional products. Professional users may choose to buy the iMac due to its relative price performance, use of a more powerful Intel microprocessor, and unique design featuring a flat panel screen. Professional users may also choose to purchase iBooks instead of the Company's professional-oriented portable products due to their price performance and screen size. Additionally, significant future growth in iPod sales without corresponding growth in higher margin product sales could also reduce gross margin and operating margin percentages.

The Company expects its quarterly revenue and operating results to fluctuate for a variety of reasons.
The Company's profit margins vary among its products and its distribution channels. The Company's direct sales, primarily through its retail and online stores, generally have higher associated profitability than its indirect sales. Additionally, the Company's direct channels have traditionally had more sales of software and higher priced hardware products, which generally have higher gross margins, than its indirect channels. As a result, the Company's gross margin and operating margin percentages, as well as overall profitability may be adversely impacted as a result of a shift in product, geographic or channel mix, or new product announcements, including the transition to Intel-based Macintosh computers. In addition, the Company generally sells more product during the third month of each quarter than it does during either of the first two months, a pattern typical in the personal computer industry. This sales pattern can produce pressure on the Company's internal infrastructure during the third

Source: APPLE COMPUTER INC, 10-Q, May 05, 2006

month of a quarter and may adversely impact the Company's ability to predict its financial results accurately. Furthermore, the Company has typically experienced greater net sales in the first and fourth fiscal quarters compared to other quarters in the fiscal year due to seasonal demand related to the holiday season and the beginning of the school year. Developments late in a quarter, such as lower-than-anticipated demand for the Company's products, an internal systems failure, or failure of one of the Company's key logistics, components suppliers, or manufacturing partners, can have significant adverse impacts on the Company and its results of operations and financial condition.

The Company has higher research and development and selling, general and administrative costs, as a percentage of revenue, than many of its competitors.
The Company's ability to compete successfully and maintain attractive gross margins and revenue growth is heavily dependent upon its ability to ensure a continuing and timely flow of innovative and competitive products and technologies to the marketplace. As a result, the Company generally incurs higher research and development costs as a percentage of revenue than its competitors who sell personal computers based on other operating systems. Many of these competitors seek to compete aggressively on price and maintain very low cost structures. Further, as a result of the expansion of the Company's Retail segment and costs associated with marketing the Company's brand including its unique operating system, the Company incurs higher selling costs as a percentage of revenue than many of its competitors. If the Company is unable to continue to develop and sell innovative new products with attractive gross margins, its results of operations may be materially adversely affected by its operating cost structure.

The Company is exposed to credit risk on its accounts receivable and prepayments related to long-term supply agreements. This risk is heightened during periods when economic conditions worsen.
The Company distributes its products through third-party computer resellers and retailers and directly to certain educational institutions and commercial customers. A substantial majority of the Company's outstanding trade receivables are not covered by collateral or credit insurance. The Company also has unsecured non-trade receivables from certain of its manufacturing vendors resulting from the sale by the Company of raw material components to these manufacturing vendors who manufacture sub-assemblies or assemble final products for the Company. In addition, the Company has entered into long-term supply agreements to secure supply of NAND flash-memory and has prepaid a total of $1.25 billion under these agreements. While the Company has procedures in place to monitor and limit exposure to credit risk on its trade and non-trade receivables as well as long-term prepayments, there can be no assurance that such procedures will be effective in limiting its credit risk and avoiding losses. Additionally, if the global economy and regional economies fail to improve or continue to deteriorate, it becomes more likely that the Company will incur a material loss or losses as a result of the weakening financial condition of one or more of its customers or manufacturing vendors.

The Company's success depends largely on its ability to attract and retain key personnel.
Much of the future success of the Company depends on the continued service and availability of skilled personnel, including its Chief Executive Officer, members of its executive team, and those in technical, marketing and staff positions. Experienced personnel in the information technology industry are in high demand and competition for their talents is intense, especially in the Silicon Valley, where the majority of the Company's key employees are located. The Company has relied on its ability to grant stock options as one mechanism for recruiting and retaining this highly skilled talent. Recent accounting regulations requiring the expensing of stock options have resulted in increased stock-based compensation expense, which may cause the Company to reduce the amount of stock-based awards issued to employees. There can be no assurance that the Company will continue to successfully attract and retain key personnel.

The Company is subject to risks associated with the selection, availability, and cost of insurance.
The Company has observed rapidly changing conditions in the insurance markets relating to nearly all areas of traditional commercial insurance. Such conditions have and may continue to result in higher premium costs, higher policy deductibles, lower coverage limits and may also yield possible policy form exclusions. For some risks, because of cost and/or availability, the Company does not have insurance coverage. Because the Company retains some portion of its insurable risks, and in some cases self insures completely, unforeseen or catastrophic losses in excess of insured limits may have a material adverse effect on the Company's results of operations and financial position.

Failure of information technology systems and breaches in the security of data upon which the Company relies could adversely affect the Company's future operating results.
Information technology system failures and breaches of data security could disrupt the Company's ability to function

Source: APPLE COMPUTER INC, 10-Q, May 05, 2006

in the normal course of business by potentially causing delays or cancellation of customer orders, impeding the manufacture or shipment of products, or resulting in the unintentional disclosure of customer or Company information. Management has taken steps to address these concerns for its own systems by implementing sophisticated network security and internal control measures. However, there can be no assurance that a system failure or data security breach of the Company or a third-party vendor will not have a material adverse effect on the Company's results of operations.

The Company's business is subject to the risks of international operations.
A large portion of the Company's revenue is derived from its international operations. As a result, the Company's operating results and financial condition could be significantly affected by risks associated with international activities, including economic and labor conditions, political instability, tax laws (including U.S. taxes on foreign subsidiaries), and changes in the value of the U.S. dollar versus the local currency in which the products are sold and goods and services are purchased. The Company's primary exposure to movements in foreign currency exchange rates relate to non-dollar denominated sales in Europe, Japan, Australia, Canada, and certain parts of Asia and non-dollar denominated operating expenses incurred throughout the world. Weaknesses in foreign currencies, particularly the Japanese Yen and the Euro, can adversely impact consumer demand for the Company's products and the U.S. dollar value of the Company's foreign currency denominated sales. Conversely, a strengthening in these and other foreign currencies can cause the Company to modify international pricing and affect the value of the Company's foreign denominated sales, and in some cases, may also increase the cost to the Company of some product components.

Margins on sales of the Company's products in foreign countries, and on sales of products that include components obtained from foreign suppliers, can be adversely affected by foreign currency exchange rate fluctuations and by international trade regulations, including tariffs and antidumping penalties.

Derivative instruments, such as foreign exchange forward and option positions have been utilized by the Company to hedge exposures to fluctuations in foreign currency exchange rates. The use of such hedging activities may not offset more than a portion of the adverse financial impact resulting from unfavorable movements in foreign exchange rates.

Further information related to the Company's global market risks may be found in Part II, Item 7A of the 2005 Form 10-K for the year ended September 24, 2005 under the subheading "Foreign Currency Risk" and may be found in Part II, Item 8 of the 2005 Form 10-K for the year ended September 24, 2005 at Notes 1 and 2 of Notes to Consolidated Financial Statements.

The Company is subject to risks associated with environmental regulations.
Production and marketing of products in certain states and countries may subject the Company to environmental and other regulations including, in some instances, the requirement to provide customers the ability to return product at the end of its useful life, and place responsibility for environmentally safe disposal or recycling with the Company. Such laws and regulations have recently been passed in several jurisdictions in which the Company operates, including various European Union member countries, Japan, and certain states within the U.S. In the future, these laws could have a material adverse effect on the Company's results of operations.

Changes in accounting rules could affect the Company's future operating results.
Financial statements are prepared in accordance with U.S. generally accepted accounting principles. These principles are subject to interpretation by various governing bodies, including the FASB and the SEC, who create and interpret appropriate accounting standards. A change from current accounting standards could have a significant effect on the Company's results of operations. In December 2004, the FASB issued new guidance that addresses the accounting for share-based payments, SFAS No. 123R, which the Company adopted in the first quarter of 2006. In the second quarter and first six months of 2006, stock-based compensation expense reduced diluted earnings per common share by approximately $0.03 and $0.07, respectively. Although the effect from the adoption of SFAS No. 123R is expected to continue to have a material impact on the Company's results of operations, future changes to various assumptions used to determine the fair-value of awards issued or the amount and type of equity awards granted create uncertainty as to the amount of future stock-based compensation expense.

Source: APPLE COMPUTER INC, 10-Q, May 05, 2006

Changes in the Company's tax rates could affect its future results.
The Company's future effective tax rates could be favorably or unfavorably affected by changes in the mix of earnings in countries with differing statutory tax rates, changes in the valuation of the Company's deferred tax assets and liabilities, or by changes in tax laws or their interpretation. In addition, the Company is subject to the continuous examination of its income tax returns by the Internal Revenue Service and other tax authorities. The Company regularly assesses the likelihood of adverse outcomes resulting from these examinations to determine the adequacy of its provision for income taxes. There can be no assurance that the outcomes from these continuous examinations will not have an adverse effect on the Company's results of operations and financial condition.

The Company's stock price may be volatile.
The Company's stock has at times experienced substantial price volatility as a result of variations between its actual and anticipated financial results and as a result of announcements by the Company and its competitors. The stock market has experienced extreme price and volume fluctuations that have affected the market price of many technology companies in ways that may have been unrelated to the operating performance of these companies. Furthermore, the Company believes its stock price reflects high future growth and profitability expectations. If the Company fails to meet these expectations its stock price may significantly decline. These factors, including lack of positive general economic and political conditions and investors' concerns regarding the credibility of corporate financial reporting and integrity of financial markets, may materially adversely affect the market price of the Company's stock in the future. In addition, increases in the Company's stock price may result in greater dilution of earnings per share.

For a discussion of these and other factors affecting the Company's future results and financial condition, see Item 7, "Management's Discussion and Analysis – Factors That May Affect Future Results and Financial Condition" and Item 1, "Business" in the Company's 2005 Form 10-K.

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

c) Issuer Purchases of Equity Securities (in millions, except share and per share amounts):

Period	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Approximate Dollar Value of Shares That May Yet Be Purchased Under the Plans or Programs
January 1, 2006 – February 4, 2006	—	—	—	—
February 5, 2006 – March 4, 2006	—	—	—	—
March 5, 2006 – April 1, 2006 (1)	4,573,553	$ 64.66	4,573,553	$ 283

(1) During the second quarter of 2006, the Company withheld a total of 4.6 million shares of its common stock at a price of $64.66 per share related to the net-share settlement upon vesting of restricted stock to pay the CEO's minimum statutory obligation for the applicable income and other employment taxes. This share withholding was not part of the Company's authorized stock repurchase plan. In addition, during the second quarter of 2006, 2.4 million restricted stock units vested, of which the Company withheld 954,079 shares in order to pay the employees' tax obligations to taxing authorities. The number of shares withheld was based on the value of the restricted stock units on their vesting date as determined by the Company's closing stock price of $59.96. These restricted stock units are not registered pursuant to section 12 of the Exchange Act and were not part of the Company's authorized stock repurchase plan.

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

The annual meeting of shareholders was held on April 27, 2006. Proposals 1 and 2 were approved. Proposal 3 was not approved. The results are as follows:

Proposal 1

The following directors were elected at the meeting to serve a one-year term as directors:

Source: APPLE COMPUTER INC, 10-Q, May 05, 2006

	For	Authority Withheld
Fred D. Anderson	702,719,143	15,374,778
William V. Campbell	702,951,247	15,142,674
Millard S. Drexler	703,091,225	15,002,696
Albert A. Gore, Jr.	701,039,068	17,054,853
Steven P. Jobs	703,459,852	14,634,069
Arthur D. Levinson	703,152,546	14,941,375
Jerome B. York	703,176,234	14,917,687

Proposal 2

Ratification of appointment of KPMG LLP as the Company's independent auditors for fiscal year 2006.

For	Against	Abstained
700,315,183	10,953,333	6,825,408

Proposal 3

A shareholder proposal requesting that the Board of Directors prepare a report studying ways to improve its computer recycling programs.

For	Against	Abstained	Broker Non-Vote
44,893,528	436,426,142	64,821,205	171,953,049

The proposals above are described in detail in the Company's definitive proxy statement dated March 13, 2006, for the Annual Meeting of Shareholders held on April 27, 2006.

Source: APPLE COMPUTER INC, 10-Q, May 05, 2006

Item 6. Exhibits

(a) Index to Exhibits

Exhibit Number	Exhibit Description	Incorporated by Reference Form	Filing Date/ Period End Date	Filed Herewith
3.1	Restated Articles of Incorporation, filed with the Secretary of State of the State of California on January 27, 1988.	S-3	7/27/88	
3.2	Amendment to Restated Articles of Incorporation, filed with the Secretary of State of the State of California on May 4, 2000.	10-Q	5/11/00	
3.3	By-Laws of the Company, as amended through June 7, 2004.	10-Q	6/26/04	
3.4	Certificate of Amendment to Restated Articles of Incorporation, as amended, filed with the Secretary of State of the State of California on February 25, 2005.	10-Q	3/26/05	
4.2	Indenture dated as of February 1, 1994, between the Company and Morgan Guaranty Trust Company of New York.	10-Q	4/01/94	
4.3	Supplemental Indenture dated as of February 1, 1994, among the Company, Morgan Guaranty Trust Company of New York, as resigning trustee, and Citibank, N.A., as successor trustee.	10-Q	4/01/94	
4.5	Form of the Company's 6 1/2% Notes due 2004.	10-Q	4/01/94	
4.8	Registration Rights Agreement, dated June 7, 1996 among the Company and Goldman, Sachs & Co. and Morgan Stanley & Co. Incorporated.	S-3	8/28/96	
4.9	Certificate of Determination of Preferences of Series A Non-Voting Convertible Preferred Stock of Apple Computer, Inc.	10-K	9/26/97	
10.A.3	Apple Computer, Inc. Savings and Investment Plan, as amended and restated effective as of October 1, 1990.	10-K	9/27/91	
10.A.3-1	Amendment of Apple Computer, Inc. Savings and Investment Plan dated March 1, 1992.	10-K	9/25/92	
10.A.3-2	Amendment No. 2 to the Apple Computer, Inc. Savings and Investment Plan.	10-Q	3/28/97	
10.A.5	1990 Stock Option Plan, as amended through November 5, 1997.	10-Q	12/26/97	
10.A.6	Apple Computer, Inc. Employee Stock Purchase Plan, as amended through April 21, 2005.	10-Q	3/26/05	
10.A.8	Form of Indemnification Agreement between the Registrant and each officer of the Registrant.	10-K	9/26/97	

Source: APPLE COMPUTER INC, 10-Q, May 05, 2006

10.A.43	NeXT Computer, Inc. 1990 Stock Option Plan, as amended.	S-8	3/21/97	
10.A.49	1997 Employee Stock Option Plan, as amended through October 19, 2001.	10-K	9/28/02	
10.A.50	1997 Director Stock Option Plan.	10-Q	3/27/98	
10.A.51	2003 Employee Stock Plan, as amended through November 9, 2005.	10-K	9/24/05	
10.A.52	Reimbursement Agreement dated as of May 25, 2001 by and between the Registrant and Steven P. Jobs.	10-Q	6/29/02	
10.A.53	Option Cancellation and Restricted Stock Award Agreement dated as of March 19, 2003 by and between The Registrant and Steven P. Jobs.	10-Q	6/28/03	
10.A.54	Form of Restricted Stock Unit Award Agreement.	10-Q	3/27/04	
10.A.54-1	Alternative Form of Restricted Stock Unit Award Agreement.	10-K	9/24/05	
10.A.55	Apple Computer, Inc. Performance Bonus Plan dated April 21, 2005.	10-Q	3/26/05	
10.A.56	Form of Election to Satisfy Tax Withholding with Stock.	8-K	8/15/05	
10.A.57	Form of Option Agreements.	10-K	9/24/05	
10.B.18*	Custom Sales Agreement effective October 21, 2002 between the Registrant and International Business Machines Corporation.	10-K	9/27/03	
10.B.19*	Purchase Agreement effective August 10, 2005 between the Registrant and Freescale Semiconductor, Inc.	10-K	9/24/05	
14.1	Code of Ethics of the Company.	10-K	9/27/03	
31.1	Rule13a-14(a) / 15d-14(a) Certification of Chief Executive Officer.			X
31.2	Rule13a-14(a) / 15d-14(a) Certification of Chief Financial Officer.			X
32.1	Section 1350 Certifications of Chief Executive Officer and Chief Financial Officer.			X

* Confidential treatment requested as to certain portion of this exhibit.

Source: APPLE COMPUTER INC, 10-Q, May 05, 2006

SIGNATURE

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.

May 4, 2006

APPLE COMPUTER, INC.

By: /s/ Peter Oppenheimer
Peter Oppenheimer
Senior Vice President and
Chief Financial Officer

Source: APPLE COMPUTER INC, 10-Q, May 05, 2006

Exhibit 31.1

CERTIFICATIONS

I, Steven P. Jobs, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Apple Computer, 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(s) 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 (the registrant's fourth fiscal quarter in the case of an annual report) 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(s) 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 (or persons performing the equivalent functions):

   (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.

Date: May 4, 2006

By: /s/ Steven P. Jobs
Steven P. Jobs
Chief Executive Officer

Source: APPLE COMPUTER INC, 10-Q, May 05, 2006

Exhibit 31.2

CERTIFICATIONS

I, Peter Oppenheimer, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Apple Computer, 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(s) 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 (the registrant's fourth fiscal quarter in the case of an annual report) 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(s) 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 registrant's board of directors (or persons performing the equivalent functions):

   (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.

Date: May 4, 2006

By: /s/ Peter Oppenheimer
Peter Oppenheimer
Senior Vice President and
Chief Financial Officer

Source: APPLE COMPUTER INC, 10-Q, May 05, 2006

Exhibit 32.1

CERTIFICATION OF CHIEF EXECUTIVE OFFICER AND CHIEF FINANCIAL OFFICER PURSUANT TO 18 U.S.C. SECTION 1350, AS ADOPTED PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

I, Steven P. Jobs, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that the Quarterly Report of Apple Computer, Inc. on Form 10-Q for the period ended April 1, 2006 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that information contained in such Form 10-Q fairly presents in all material respects the financial condition and results of operations of Apple Computer, Inc.

By: /s/ Steven P. Jobs
Steven P. Jobs
Chief Executive Officer

I, Peter Oppenheimer, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that the Quarterly Report of Apple Computer, Inc. on Form 10-Q for the period ended April 1, 2006 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that information contained in such Form 10-Q fairly presents in all material respects the financial condition and results of operations of Apple Computer, Inc.

By: /s/ Peter Oppenheimer
Peter Oppenheimer
Senior Vice President and Chief Financial Officer

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Source: APPLE COMPUTER INC, 10-Q, May 05, 2006

EXHIBIT CO 0732

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FORM 10-Q

APPLE COMPUTER INC - AAPL

Filed: February 03, 2006 (period: December 31, 2005)

Quarterly report which provides a continuing view of a company's financial position

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OTHER INFORMATION

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SIGNATURE

EX-31.1 (302 CERTIFICATION)

EX-31.2 (302 CERTIFICATION)

EX-32.1 (906 CERTIFICATION)

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 December 31, 2005

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: 000–10030

APPLE COMPUTER, INC.

(Exact name of Registrant as specified in its charter)

CALIFORNIA (State or other jurisdiction of incorporation or organization)	**942404110** (I.R.S. Employer Identification No.)
1 Infinite Loop **Cupertino, California** (Address of principal executive offices)	**95014** (Zip Code)

Registrant's telephone number, including area code: **(408) 996–1010**

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 ☒

848,612,359 shares of common stock issued and outstanding as of January 25, 2006

Source: APPLE COMPUTER INC, 10-Q, February 03, 2006

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

APPLE COMPUTER, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (Unaudited)
(in millions, except share and per share amounts)

	Three Months Ended	
	December 31, 2005	December 25, 2004
Net sales	$ 5,749	$ 3,490
Cost of sales (including stock-based compensation expense of $5 and $0, respectively)	4,185	2,494
Gross margin	1,564	996
Operating expenses:		
Research and development (including stock-based compensation expense of $15 and $2, respectively)	182	123
Selling, general, and administrative (including stock-based compensation expense of $24 and $8, respectively)	632	470
Total operating expenses	814	593
Operating income	750	403
Other income and expense	81	26
Income before provision for income taxes	831	429
Provision for income taxes	266	134
Net income	$ 565	$ 295
Earnings per common share:		
Basic	$ 0.68	$ 0.37
Diluted	$ 0.65	$ 0.35
Shares used in computing earnings per share (in thousands):		
Basic	830,781	789,032
Diluted	874,207	838,174

See accompanying notes to condensed consolidated financial statements.

Source: APPLE COMPUTER INC, 10-Q, February 03, 2006

APPLE COMPUTER, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS (Unaudited)
(in millions, except share amounts)

	December 31, 2005	September 24, 2005
ASSETS:		
Current assets:		
Cash and cash equivalents	$ 4,150	$ 3,491
Short-term investments	4,557	4,770
Accounts receivable, less allowances of $50 and $46, respectively	1,331	895
Inventories	244	165
Deferred tax assets	471	331
Other current assets	1,409	648
Total current assets	12,162	10,300
Property, plant and equipment, net	855	817
Goodwill	69	69
Acquired intangible assets	24	27
Other assets	1,071	338
Total assets	$ 14,181	$ 11,551
LIABILITIES AND SHAREHOLDERS' EQUITY:		
Current liabilities:		
Accounts payable	$ 2,896	$ 1,779
Accrued expenses	2,164	1,705
Total current liabilities	5,060	3,484
Non-current liabilities	741	601
Total liabilities	5,801	4,085
Commitments and contingencies		
Shareholders' equity:		
Common stock, no par value; 1,800,000,000 shares authorized; 845,617,174 and 835,019,364 shares issued and outstanding, respectively	3,815	3,521
Deferred stock compensation	—	(60)
Retained earnings	4,570	4,005
Accumulated other comprehensive income (loss)	(5)	—
Total shareholders' equity	8,380	7,466
Total liabilities and shareholders' equity	$ 14,181	$ 11,551

See accompanying notes to condensed consolidated financial statements.

Source: APPLE COMPUTER INC, 10-Q, February 03, 2006

APPLE COMPUTER, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)
(in millions)

	Three Months Ended	
	December 31, 2005	December 25, 2004
Cash and cash equivalents, beginning of the period	$ 3,491	$ 2,969
Operating Activities:		
Net income	565	295
Adjustments to reconcile net income to cash generated by operating activities:		
Depreciation, amortization, and accretion	52	41
Stock-based compensation expense	44	10
Provision for (benefit from) deferred income taxes	70	(8)
Excess tax benefits from stock options	—	140
Loss on disposition of property, plant, and equipment	—	2
Changes in operating assets and liabilities:		
Accounts receivable	(436)	(91)
Inventories	(79)	(55)
Other current assets	(757)	(87)
Other assets	(771)	(27)
Accounts payable	1,117	286
Other liabilities	478	269
Cash generated by operating activities	283	775
Investing Activities:		
Purchases of short-term investments	(3,185)	(2,393)
Proceeds from maturities of short-term investments	3,396	777
Proceeds from sales of short-term investments	—	138
Purchases of property, plant, and equipment	(82)	(58)
Other	(36)	13
Cash generated by (used for) investing activities	93	(1,523)
Financing Activities:		
Proceeds from issuance of common stock	134	254
Excess tax benefits from stock-based compensation	149	—
Cash generated by financing activities	283	254
Increase (decrease) in cash and cash equivalents	659	(494)
Cash and cash equivalents, end of the period	$ 4,150	$ 2,475
Supplemental cash flow disclosures:		
Cash paid for income taxes, net	$ 22	$ 37

See accompanying notes to condensed consolidated financial statements.

Source: APPLE COMPUTER INC, 10-Q, February 03, 2006

Note 1 — Summary of Significant Accounting Policies

Apple Computer, Inc. and its subsidiaries (the Company) designs, manufactures, and markets personal computers and related software, services, peripherals, and networking solutions. The Company also designs, develops, and markets a line of portable digital music players along with related accessories and services including the online distribution of third-party music, audio books, music videos, short films, and television shows. The Company sells its products worldwide through its online stores, its own retail stores, its direct sales force, and third-party wholesalers, resellers, and value-added resellers. In addition to its own hardware, software, and peripheral products, the Company sells a variety of third-party hardware and software products through its online and retail stores. The Company sells to education, consumer, creative professional, business, and government customers.

Basis of Presentation and Preparation
The accompanying condensed consolidated financial statements include the accounts of the Company. Intercompany accounts and transactions have been eliminated. The preparation of these condensed consolidated financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in these condensed consolidated financial statements and accompanying notes. Actual results could differ materially from those estimates. Certain prior year amounts in the consolidated financial statements and notes thereto have been reclassified to conform to the current year presentation.

These condensed consolidated financial statements and accompanying notes should be read in conjunction with the Company's annual consolidated financial statements and the notes thereto for the fiscal year ended September 24, 2005, included in its Annual Report on Form 10-K for the year ended September 24, 2005 (the 2005 Form 10-K).

The Company's fiscal year is the 52 or 53-week period that ends on the last Saturday of September. The Company's first quarter of fiscal year 2006 contained 14 weeks and the first quarter of its fiscal year 2005 contained 13 weeks. The Company's fiscal year 2006 will end on September 30, 2006 and include 53 weeks while fiscal year 2005 included 52 weeks. Unless otherwise stated, references to particular years or quarters refer to the Company's fiscal years ended in September and the associated quarters of those fiscal years.

Common Stock Split
On February 28, 2005, the Company effected a two-for-one stock split to shareholders of record as of February 18, 2005. All share and per share information has been retroactively adjusted to reflect the stock split.

Software Development Costs
Research and development costs are expensed as incurred. Development costs of computer software to be sold, leased, or otherwise marketed are subject to capitalization beginning when a product's technological feasibility has been established and ending when a product is available for general release to customers pursuant to Statement of Financial Accounting Standards (SFAS) No. 86, *Computer Software to be Sold, Leased, or Otherwise Marketed.* In most instances, the Company's products are released soon after technological feasibility has been established. Therefore, costs incurred subsequent to achievement of technological feasibility are usually not significant, and generally all software development costs have been expensed.

In the fourth quarter of 2004, the Company began incurring substantial development costs associated with Mac OS X version 10.4 Tiger subsequent to achievement of technological feasibility as evidenced by public demonstration in August 2004 and the subsequent release of a developer beta version of the product. During the first quarter of 2005, the Company capitalized approximately $14.8 million of costs associated with the development of Tiger. In accordance with SFAS No. 86, amortization of this asset to cost of sales began in April 2005 when the Company began shipping Tiger and is being recognized on a straight-line basis over a three-year estimated useful life.

Stock-Based Compensation
On September 25, 2005, the Company adopted SFAS No. 123 (revised 2004) (SFAS No. 123R), *Share-Based Payment*, which addresses the accounting for stock-based payment transactions in which an enterprise receives

Source: APPLE COMPUTER INC, 10-Q, February 03, 2006

employee services in exchange for (a) equity instruments of the enterprise or (b) liabilities that are based on the fair value of the enterprise's equity instruments or that may be settled by the issuance of such equity instruments. In January 2005, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin (SAB) No. 107, which provides supplemental implementation guidance for SFAS No. 123R. SFAS No. 123R eliminates the ability to account for stock-based compensation transactions using the intrinsic value method under Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*, and instead generally require that such transactions be accounted for using a fair-value-based method. The Company uses the Black-Scholes-Merton ("BSM") option-pricing model to determine the fair-value of stock-based awards under SFAS No. 123R, consistent with that used for pro forma disclosures under SFAS No. 123, *Accounting for Stock-Based Compensation*. The Company has elected the modified prospective transition method as permitted by SFAS No. 123R and accordingly prior periods have not been restated to reflect the impact of SFAS No. 123R. The modified prospective transition method requires that stock-based compensation expense be recorded for all new and unvested stock options, restricted stock, restricted stock units, and employee stock purchase plan shares that are ultimately expected to vest as the requisite service is rendered beginning on September 25, 2005, the first day of the Company's fiscal year 2006. Stock-based compensation expense for awards granted prior to September 25, 2005 is based on the grant date fair-value as determined under the pro forma provisions of SFAS No. 123. The Company has recorded an incremental $32 million of stock-based compensation expense during the first quarter of 2006 as a result of the adoption of SFAS No. 123R. In accordance with SFAS No. 123R, beginning in the first quarter of 2006 the Company has presented excess tax benefits from the exercise of stock-based compensation awards as a financing activity in the Condensed Consolidated Statement of Cash Flows.

No stock-based compensation costs were capitalized as part of the cost of an asset as of December 31, 2005. The income tax benefit related to stock-based compensation expense was $14 million for the quarter ended December 31, 2005. As of December 31, 2005, $398 million of total unrecognized compensation cost related to stock options and restricted stock units are expected to be recognized over a weighted-average period of 2 years.

Prior to the adoption of SFAS No. 123R, the Company measured compensation expense for its employee stock-based compensation plans using the intrinsic value method prescribed by APB Opinion No. 25. The Company applied the disclosure provisions of SFAS No. 123 as amended by SFAS No. 148, *Accounting for Stock-Based Compensation — Transition and Disclosure* as if the fair-value-based method had been applied in measuring compensation expense. Under APB Opinion No. 25, when the exercise price of the Company's employee stock options was equal to the market price of the underlying stock on the date of the grant, no compensation expense was recognized.

The following table illustrates the effect on net income after taxes and net income per common share as if the Company had applied the fair value recognition provisions of SFAS No. 123 to stock-based compensation during the three-month period ended December 25, 2004 (in millions, except per share amounts):

	Three Months Ended 12/25/04
Net income – as reported	$ 295
Add: Stock-based employee compensation expense included in reported net income, net of tax	9
Deduct: Stock-based employee compensation expense determined under the fair value based method for all awards, net of tax	(29)
Net income – pro forma	$ 275
Net income per common share – as reported	
Basic	$ 0.37
Diluted	$ 0.35
Net income per common share – pro forma	
Basic	$ 0.35
Diluted	$ 0.33

Source: APPLE COMPUTER INC, 10-Q, February 03, 2006

Further information regarding stock-based compensation can be found in Note 6 of these Notes to Condensed Consolidated Financial Statements.

Earnings Per Share

Basic earnings per common share is computed by dividing income available to common shareholders by the weighted-average number of shares of common stock outstanding during the period. Diluted earnings per common share is computed by dividing income available to common shareholders by the weighted-average number of shares of common stock outstanding during the period increased to include the number of additional shares of common stock that would have been outstanding if the dilutive potential shares of common stock had been issued. The dilutive effect of outstanding options, restricted stock and restricted stock units is reflected in diluted earnings per share by application of the treasury stock method. Under the treasury stock method, an increase in the fair market value of the Company's common stock can result in a greater dilutive effect from outstanding options, restricted stock, and restricted stock units. Additionally, the exercise of employee stock options and the vesting of restricted stock and restricted stock units can result in a greater dilutive effect on earnings per share.

The following table sets forth the computation of basic and diluted earnings per share (in thousands, except net income and per share amounts):

	Three Months Ended	
	12/31/05	12/25/04
Numerator (in millions):		
Net income	$ 565	$ 295
Denominator:		
Weighted-average shares outstanding, excluding unvested restricted stock	830,781	789,032
Effect of dilutive options, restricted stock units, and restricted stock	43,426	49,142
Denominator for diluted earnings per share	874,207	838,174
Basic earnings per share	$ 0.68	$ 0.37
Diluted earnings per share	$ 0.65	$ 0.35

Potentially dilutive securities, including stock options, restricted stock units, and restricted stock to acquire approximately 1.6 million and 1.7 million shares of common stock for the quarters ended December 31, 2005 and December 25, 2004, respectively, were excluded from the computation of diluted earnings per share for these periods because their effect would have been antidilutive.

Source: APPLE COMPUTER INC, 10-Q, February 03, 2006

Note 2 — Financial Instruments

Cash, Cash Equivalents and Short-Term Investments

The following table summarizes the fair value of the Company's cash and available-for-sale securities held in its short-term investment portfolio, recorded as cash and cash equivalents or short-term investments as of December 31, 2005, and September 24, 2005 (in millions):

	12/31/05	9/24/05
Cash	$ 233	$ 127
U.S. Treasury and Agency securities	21	89
U.S. corporate securities	2,561	2,030
Foreign securities	1,335	1,245
Total cash equivalents	3,917	3,364
U.S. Treasury and Agency securities	296	216
U.S. corporate securities	3,220	3,662
Foreign securities	1,041	892
Total short-term investments	4,557	4,770
Total cash, cash equivalents, and short-term investments	$ 8,707	$ 8,261

The Company's U.S. corporate securities consist primarily of commercial paper, certificates of deposit, time deposits, and corporate debt securities. Foreign securities consist primarily of foreign commercial paper, certificates of deposit, and time deposits with foreign institutions, most of which are denominated in U.S. dollars. The Company had net unrealized losses totaling $6.7 million on its investment portfolio, the majority of which related to investments with stated maturities less than one year as of December 31, 2005 and net unrealized losses of $5.9 million on its investment portfolio, approximately half of which related to investments with stated maturities less than one year as of September 24, 2005.

As of December 31, 2005 and September 24, 2005, approximately $172 million and $287 million, respectively, of the Company's short-term investments had underlying maturities ranging from one to five years. The remaining short-term investments had maturities of three to 12 months.

Derivative Financial Instruments

The Company uses derivatives to partially offset its business exposure to foreign exchange and interest rate risk. Foreign currency forward and option contracts are used to offset the foreign exchange risk on certain existing assets and liabilities and to hedge the foreign exchange risk on expected future cash flows on certain forecasted revenue and cost of sales. From time to time, the Company enters into interest rate derivative agreements to modify the interest rate profile of certain investments and debt. The Company's accounting policies for these instruments are based on whether the instruments are designated as hedge or non-hedge instruments. The Company records all derivatives on the balance sheet at fair value. Derivatives that are not hedges are adjusted to fair value through earnings. If the derivative is a hedge, depending on the nature of the hedge, changes in fair value will either be offset against the change in fair value of the hedged assets, liabilities, or firm commitments through earnings, or recognized in other comprehensive income until the hedged item is recognized in earnings. As of December 31, 2005, the Company had a net deferred gain associated with cash flow hedges of approximately $5.5 million net of taxes, substantially all of which is expected to be reclassified to earnings by the end of the third quarter of fiscal 2006. As of the end of the first quarter of 2006, the general nature of the Company's risk management activities and the general nature and mix of the Company's derivative financial instruments have not changed materially from the end of 2005.

Foreign Exchange Risk Management

The Company may enter into foreign currency forward and option contracts with financial institutions to protect against foreign exchange risk associated with existing assets and liabilities, certain firmly committed transactions, forecasted future cash flows, and net investments in foreign subsidiaries. Generally, the Company's practice is to hedge a majority of its existing material foreign exchange transaction exposures. However, the Company may not

Source: APPLE COMPUTER INC, 10-Q, February 03, 2006

hedge certain foreign exchange transaction exposures due to immateriality, prohibitive economic cost of hedging particular exposures, or limited availability of appropriate hedging instruments.

Note 3 — Condensed Consolidated Financial Statement Details (in millions)

Other Current Assets

	12/31/05	9/24/05
Vendor non-trade receivables	$ 1,082	$ 417
Other current assets	327	231
Total other current assets	$ 1,409	$ 648

Property, Plant, and Equipment, Net

	12/31/05	9/24/05
Land and buildings	$ 361	$ 361
Machinery, equipment, and internal-use software	499	470
Office furniture and equipment	85	81
Leasehold improvements	602	569
	1,547	1,481
Accumulated depreciation and amortization	(692)	(664)
Total property, plant, and equipment, net	$ 855	$ 817

Other Assets

	12/31/05	9/24/05
Long-term NAND flash memory prepayments	$ 750	$ —
Non-current deferred tax assets	122	183
Capitalized software development costs, net	34	38
Other assets	165	117
Total other assets	$ 1,071	$ 338

Accrued Expenses

	12/31/05	9/24/05
Deferred revenue – current	$ 630	$ 501
Accrued marketing and distribution	204	221
Accrued compensation and employee benefits	164	167
Accrued warranty and related costs	247	188
Other current liabilities	919	628
Total accrued expenses	$ 2,164	$ 1,705

Non-Current Liabilities

	12/31/05	9/24/05
Deferred revenue – non-current	$ 298	$ 281
Deferred tax liabilities	430	308
Other non-current liabilities	13	12
Total non-current liabilities	$ 741	$ 601

Source: APPLE COMPUTER INC, 10-Q, February 03, 2006

Claire Enders

PROFESSIONAL EXPERIENCE

1997- **Enders Analysis** (http://www.endersanalysis.com/)
Chief Executive
Presentations, reports and notes for subscribers and consultancy clients on commercial and strategic issues arising out of technology change in the media, internet and mobile and fixed-line telecommunications sectors in Europe, the US and Japan.

1992-97 **Thorn EMI plc**
Corporate Development Manager
Reporting to the Executive Chairman and the Finance Director on group strategy, the strategy of other companies in the entertainment sector in general and recorded music and music publishing in particular, potential investments and acquisitions and regulatory issues. Managed four Monopolies and Mergers Commission inquiries and two filings with the European Commission Competition Directorate. Was on secondment to the Department of Trade and Industry as the Special Adviser on broadcasting policy for 1994.

1989-92 **TVS Entertainment**
Director of Corporate Development
Responsible for group strategy, corporate development activity and related regulatory issues for the former ITV broadcaster for the South and South-East of England.

1986-89 **Superchannel**
Director of Marketing
Responsible for commercial strategy for the pan-European satellite channel then owned by the ITV companies.

1984-86 **The Virgin Group**
Head of Business Development
Responsible for development of The Virgin Group's media activities, including investments in new media.

EDUCATION

1984 London Business School, MBA
1979 Yale University, BA (Hons) History

Other Income and Expense

	Three Months Ended	
	12/31/05	12/25/04
Interest income	$ 88	$ 28
Other expense, net	(7)	(2)
Other income and expense	$ 81	$ 26

Note 4 — Restructuring Actions

2004 Restructuring Actions

The Company recorded total restructuring charges of approximately $23 million during 2004, including approximately $14 million in severance costs, $5.5 million in asset impairments, and a $3.5 million charge for lease cancellations in conjunction with the vacating of a leased sales facility related to a European workforce reduction during the fourth quarter of 2004. Of the $23 million charge, $20.4 million had been utilized by the end of the first quarter of 2006, with the remaining $2.6 million consisting of $0.2 million for employee severance benefits and $2.4 million for lease cancellations. These actions will result in the termination of 452 positions, 450 of which had been terminated prior to the end of the first quarter of 2006.

The following table summarizes activity associated with restructuring actions initiated during 2004 (in millions):

	Employee Severance Benefits	Asset Impairments	Lease Cancellations	Totals
Total charge	$ 14.0	$ 5.5	$ 3.5	$ 23.0
Total spending through December 31, 2005	(12.5)	—	(1.1)	(13.6)
Total non-cash items	—	(5.2)	—	(5.2)
Adjustments	(1.3)	(0.3)	—	(1.6)
Accrual at December 31, 2005	$ 0.2	$ —	$ 2.4	$ 2.6

2003 Restructuring Actions

The Company recorded total restructuring charges of approximately $26.8 million during 2003, including approximately $7.4 million in severance costs, a $5.0 million charge to write off deferred compensation, $7.1 million in asset impairments and a $7.3 million charge for lease cancellations primarily related to the closure of the Company's Singapore manufacturing operations during the first quarter of 2003. Of the $26.8 million charge, all had been utilized by the end of the first quarter of 2006, except for approximately $1.6 million related to operating lease costs on abandoned facilities.

The following table summarizes activity associated with restructuring actions initiated during 2003 (in millions):

	Employee Severance Benefits	Deferred Compensation Write-off	Asset Impairments	Lease Cancellations	Totals
Total charge	$ 7.4	$ 5.0	$ 7.1	$ 7.3	$ 26.8
Total spending through December 31, 2005	(7.9)	—	—	(5.2)	(13.1)
Total non-cash items	—	(5.0)	(7.1)	—	(12.1)
Adjustments	0.5	—	—	(0.5)	—
Accrual at December 31, 2005	$ —	$ —	$ —	$ 1.6	$ 1.6

Source: APPLE COMPUTER INC, 10-Q, February 03, 2006

Note 5 — Shareholders' Equity

Preferred Stock

The Company has 5 million shares of authorized preferred stock, none of which is outstanding. Under the terms of the Company's Restated Articles of Incorporation, the Board of Directors is authorized to determine or alter the rights, preferences, privileges and restrictions of the Company's authorized but unissued shares of preferred stock.

Restricted Stock Units

The Company's Board of Directors has approved several grants of restricted stock units to members of the Company's senior management team, excluding its CEO. These restricted stock units generally vest over four years either in two equal installments on the second and fourth anniversaries of the date of grant or in equal installments on each of the first through fourth anniversaries of the grant date. Upon vesting, the restricted stock units will convert into an equivalent number of shares of common stock. The value of the restricted stock units is based on the closing market price of the Company's common stock on the date of grant and are amortized on a straight-line basis over the four-year requisite service period. The restricted stock units have been reflected in the calculation of diluted earnings per share utilizing the treasury stock method.

CEO Restricted Stock Award

On March 19, 2003, the Company entered into an Option Cancellation and Restricted Stock Award Agreement (the Agreement) with Mr. Steven P. Jobs, its CEO. The Agreement cancelled stock option awards for the purchase of 55 million shares of the Company's common stock previously granted to Mr. Jobs in 2000 and 2001. Mr. Jobs retained options to purchase 120,000 shares of the Company's common stock granted in August of 1997 in his capacity as a member of the Company's Board of Directors, prior to becoming the Company's CEO. The Agreement replaced the cancelled options with a restricted stock award of 10 million shares of the Company's common stock. The restricted stock award generally vests three years from the date of grant. Vesting of some or all of the restricted shares will be accelerated in the event Mr. Jobs is terminated without cause, dies, or has his management role reduced following a change in control of the Company.

Stock Repurchase Plan

In July 1999, the Company's Board of Directors authorized a plan for the Company to repurchase up to $500 million of its common stock. This repurchase plan does not obligate the Company to acquire any specific number of shares or acquire shares over any specified period of time. The Company has not engaged in any transactions to repurchase its common stock since 2003. Since inception of the stock repurchase plan, the Company had repurchased a total of 13.1 million shares at a cost of $217 million. The Company was authorized to repurchase up to an additional $283 million of its common stock as of December 31, 2005.

Comprehensive Income

Comprehensive income consists of two components, net income and other comprehensive income. Other comprehensive income refers to revenue, expenses, gains, and losses that under U.S. generally accepted accounting principles are recorded as an element of shareholders' equity but are excluded from net income. The Company's other comprehensive income consists of foreign currency translation adjustments from those subsidiaries not using the U.S. dollar as their functional currency, unrealized gains and losses on marketable securities categorized as available-for-sale, and net deferred gains and losses on certain derivative instruments accounted for as cash flow hedges.

The following table summarizes components of total comprehensive income, net of taxes, during the three-month periods ended December 31, 2005, and December 25, 2004 (in millions):

	Three Months Ended	
	12/31/05	12/25/04
Net income	$ 565	$ 295
Other comprehensive income:		
Net change in unrealized derivative gains/losses	2	(9)
Change in foreign currency translation	(8)	22
Net change in unrealized investment gains/losses	1	(1)
Total comprehensive income	$ 560	$ 307

Source: APPLE COMPUTER INC, 10-Q, February 03, 2006

The following table summarizes activity in other comprehensive income related to derivatives, net of taxes, held by the Company during the three-month periods ended December 31, 2005, and December 25, 2004 (in millions):

	Three Months Ended	
	12/31/05	12/25/04
Change in fair value of derivatives	$ 5	$ (12)
Adjustment for net gains/losses realized and included in net income	(3)	3
Change in unrealized gain/loss on derivative instruments	$ 2	$ (9)

The following table summarizes the components of accumulated other comprehensive income (loss), net of taxes (in millions):

	As of 12/31/05	As of 9/24/05
Unrealized losses on available-for-sale securities	$ (3)	$ (4)
Unrealized gains on derivative investments	6	4
Cumulative foreign currency translation	(8)	—
Accumulated other comprehensive income (loss)	$ (5)	$ —

Employee Benefit Plans

2003 Employee Stock Option Plan
The 2003 Employee Stock Plan (the 2003 Plan) is a shareholder approved plan that provides for broad-based grants to employees, including executive officers. Based on the terms of individual option grants, options granted under the 2003 Plan generally expire seven to 10 years after the grant date and generally become exercisable over a period of four years, based on continued employment, with either annual or quarterly vesting. The 2003 Plan permits the granting of incentive stock options, nonstatutory stock options, restricted stock units, stock appreciation rights, and stock purchase rights.

1997 Employee Stock Option Plan
In August 1997, the Company's Board of Directors approved the 1997 Employee Stock Option Plan (the 1997 Plan), a non-shareholder approved plan for grants of stock options to employees who are not officers of the Company. Based on the terms of individual option grants, options granted under the 1997 Plan generally expire seven to 10 years after the grant date and generally become exercisable over a period of four years, based on continued employment, with either annual or quarterly vesting. In October 2003, the Company terminated the 1997 Plan and no new options can be granted from this plan.

1997 Director Stock Option Plan
In August 1997, the Company's Board of Directors adopted a shareholder approved Director Stock Option Plan (DSOP) for non-employee directors of the Company. Initial grants of 30,000 options under the DSOP vest in three equal installments on each of the first through third anniversaries of the date of grant, and subsequent annual grants of 10,000 options are fully vested at the date of grant. Based on the terms of individual option grants, options granted under the DSOP generally expire 10 years after the grant date.

Rule 10b5-1 Trading Plans
Certain of the Company's executive officers, including Mr. Timothy D. Cook, Mr. Peter Oppenheimer, Mr. Jonathan Rubinstein, Mr. Philip W. Schiller, Dr. Bertrand Serlet, and Dr. Avadis Tevanian, Jr., have entered into trading plans pursuant to Rule 10b5-1(c)(1) of the Securities Exchange Act of 1934, as amended. A trading plan is a written document that pre-establishes the amounts, prices and dates (or formula for determining the amounts, prices and dates) of future purchases or sales of the Company's stock including the exercise and sale of employee stock options and shares acquired pursuant to the Company's employee stock purchase plan and upon vesting of restricted stock units.

Source: APPLE COMPUTER INC, 10-Q, February 03, 2006

Employee Stock Purchase Plan

The Company has a shareholder approved employee stock purchase plan (the Purchase Plan), under which substantially all employees may purchase common stock through payroll deductions at a price equal to 85% of the lower of the fair market values as of the beginning and end of six-month offering periods. Stock purchases under the Purchase Plan are limited to 10% of an employee's compensation, up to a maximum of $25,000 in any calendar year. The number of shares authorized for issuance is limited to a total of 1 million shares per offering period. As of December 31, 2005, approximately 2.9 million shares were reserved for future issuance under the Purchase Plan.

Stock Award Activity

A summary of the Company's stock award activity and related information for the three-month periods ended December 31, 2005 and December 25, 2004 (option amounts are presented in thousands) is set forth in the following table:

		Outstanding Options	
	Shares Available For Grant	Number of Shares	Weighted-Average Exercise Price
Balance at 9/25/04	24,050	110,722	$ 10.52
Options Granted	(2,208)	2,208	$ 27.42
Options Canceled	804	(804)	$ 12.06
Options Exercised	—	(24,830)	$ 9.47
Plan Shares Expired	(304)	—	—
Balance at 12/25/04	22,342	87,296	$ 11.24
Balance at 9/24/05	58,957	73,221	$ 17.79
Options Granted	(1,202)	1,202	$ 62.93
Restricted Stock Units Granted	(2,300)	—	—
Options Canceled	641	(641)	$ 21.22
Options Exercised	—	(9,703)	$ 10.90
Plan Shares Expired	(50)	—	—
Balance at 12/31/05	56,046	64,079	$ 19.65

The options outstanding as of December 31, 2005 have been segregated into six ranges for additional disclosure as follows (option amounts are presented in thousands):

	Options Outstanding			Options Exercisable		
Range of Exercise Prices	Options Outstanding as of 12/31/05	Weighted-Average Remaining Contractual Life in Years	Weighted-Average Exercise Price	Options Exercisable as of 12/31/05	Weighted-Average Remaining Contractual Life in Years	Weighted-Average Exercise Price
$ 0.62 – $9.25	12,515	4.27	$ 7.96	11,244	4.12	$ 7.99
$ 9.26 – $10.74	9,050	5.56	$ 10.15	7,510	5.85	$ 10.16
$ 10.75 – $10.90	10,875	5.10	$ 10.89	3,090	5.09	$ 10.89
$ 10.91 – $14.03	11,081	5.02	$ 11.78	9,128	4.94	$ 11.63
$ 14.04 – $46.57	18,804	6.12	$ 38.03	3,785	6.49	$ 28.10
$ 46.58 – $74.08	1,754	6.82	$ 58.81	6	6.39	$ 49.87
$ 0.62– $74.08	64,079	5.34	$ 19.65	34,763	5.32	$ 11.87

Source: APPLE COMPUTER INC, 10-Q, February 03, 2006

Aggregate intrinsic value of options outstanding and options exercisable at December 31, 2005 was $3.3 billion and $2.1 billion, respectively. Aggregate intrinsic value represents the difference between the Company's closing stock price on the last trading day of the fiscal period, which was $71.89 as of December 30, 2005, and the exercise price multiplied by the number of options outstanding. Total intrinsic value of options exercised was $473 million and $395 million for the three-month periods ended December 31, 2005 and December 25, 2004, respectively.

The total fair value of options vested was $695 million and $377 million for the three-month periods ended December 31, 2005 and December 25, 2004, respectively.

The Company had 6.18 million restricted stock units outstanding as of December 31, 2005, which were excluded from the options outstanding balances in the preceding tables. The total weighted-average grant date fair value was $154 million. Aggregate intrinsic value of restricted stock units at December 31, 2005 was $444 million. None of these restricted stock units was vested as of December 31, 2005. The grant of these restricted stock units has been deducted from the shares available for grant under the Company's stock option plans. In conjunction with the amendments to the 2003 Plan that were approved at the Annual Meeting of Shareholders held on April 21, 2005, the number of shares available for grant under the 2003 Plan will be reduced by two times the number of restricted shares and restricted stock units granted. This amendment is effective for all grants made after April 21, 2005.

The total nonvested restricted stock outstanding at December 31, 2005 was 10 million shares. There were no grants, forfeitures, or vesting of any nonvested restricted stock during the quarter ended December 31, 2005. The weighted-average grant date fair value of outstanding nonvested restricted stock at December 31, 2005 was $7.48. As of December 31, 2005, total unrecognized compensation costs related to nonvested restricted stock was $2.3 million, which is expected to be recognized in the second quarter of 2006.

Note 6 – Stock-Based Compensation

SFAS No. 123R requires the use of a valuation model to calculate the fair value of stock-based awards. The Company has elected to use the BSM option-pricing model, which incorporates various assumptions including volatility, expected life, and interest rates. The expected volatility is based on the historical volatility of the Company's common stock over the most recent period commensurate with the estimated expected life of the Company's stock options, adjusted for the impact of unusual fluctuations not reasonably expected to recur and other relevant factors including implied volatility in market traded options on the Company's common stock. The expected life of an award is based on historical experience and on the terms and conditions of the stock awards granted to employees.

The assumptions used for the three-month periods ended December 31, 2005 and December 25, 2004 and the resulting estimates of weighted-average fair value per share of options granted and for stock purchases during those periods are as follows:

	Three Months Ended	
	12/31/05	12/25/04
Expected life of stock options	3.6 years	3.5 years
Expected life of stock purchases	6 months	6 months
Interest rate – stock options	4.19%	3.13%
Interest rate – stock purchases	3.30%	1.67%
Volatility – stock options	40.7%	40.0%
Volatility – stock purchases	48.4%	31.8%
Dividend yields	—	—
Weighted-average fair value of options granted during the period	$ 22.29	$ 9.07
Weighted-average fair value of employee stock purchases during the period	$ 10.08	$ 3.72

Source: APPLE COMPUTER INC, 10-Q, February 03, 2006

Note 7 — Commitments and Contingencies

Lease Commitments

The Company leases various equipment and facilities, including retail space, under noncancelable operating lease arrangements. The Company does not currently utilize any other off-balance sheet financing arrangements. The major facility leases are for terms of five to 15 years and generally provide renewal options for terms of three to five additional years. Leases for retail space are for terms of five to 20 years, the majority of which are for 10 years, and often contain multi-year renewal options. As of September 24, 2005, the Company's total future minimum lease payments under noncancelable operating leases were $865 million, of which $606 million related to leases for retail space. As of December 31, 2005, total future minimum lease payments related to leases for retail space increased to $705 million.

Accrued Warranty and Indemnifications

The Company offers a basic limited parts and labor warranty on its hardware products. The basic warranty period for hardware products is typically one year from the date of purchase by the end-user. The Company also offers a 90-day basic warranty for its service parts used to repair the Company's hardware products. The Company provides currently for the estimated cost that may be incurred under its basic limited product warranties at the time the related revenue is recognized. Factors considered in determining appropriate accruals for product warranty obligations include the size of the installed base of products subject to warranty protection, historical and projected warranty claim rates, historical and projected cost-per-claim, and knowledge of specific product failures that are outside of the Company's typical experience. The Company assesses the adequacy of its preexisting warranty liabilities and adjusts the amounts as necessary based on actual experience and changes in future estimates.

The following table reconciles changes in the Company's accrued warranties and related costs for the three-month periods ended December 31, 2005 and December 25, 2004 (in millions):

	Three Months Ended	
	12/31/05	12/25/04
Beginning accrued warranty and related costs	$ 188	$ 105
Cost of warranty claims	(77)	(35)
Accruals for product warranties	136	65
Ending accrued warranty and related costs	$ 247	$ 135

The Company generally does not indemnify end-users of its operating system and application software against legal claims that the software infringes third-party intellectual property rights. Other agreements entered into by the Company sometimes include indemnification provisions under which the Company could be subject to costs and/or damages in the event of an infringement claim against the Company or an indemnified third-party. However, the Company has not been required to make any significant payments resulting from such an infringement claim asserted against itself or an indemnified third-party and, in the opinion of management, does not have a potential liability related to unresolved infringement claims subject to indemnification that would have a material adverse effect on its financial condition, liquidity or results of operations. Therefore, the Company did not record a liability for infringement costs as of either December 31, 2005 or September 24, 2005.

Concentrations in the Available Sources of Supply of Materials and Product

Although most components essential to the Company's business are generally available from multiple sources, other key components (including microprocessors and application-specific integrated circuits ("ASICs")) are currently obtained by the Company from single or limited sources. Some other key components, while currently available to the Company from multiple sources, are at times subject to industry-wide availability and pricing pressures. In addition, the Company uses some components that are not common to the rest of the personal computer industry, and new products introduced by the Company often initially utilize custom components obtained from only one source until the Company has evaluated whether there is a need for and subsequently qualifies additional suppliers. If the supply of a key single-sourced component to the Company were to be delayed or curtailed, or in the event a key manufacturing vendor delays shipments of completed products to the Company, the Company's ability to ship related products in desired quantities and in a timely manner could be adversely affected. The Company's business and financial performance could also be adversely affected depending on the time required to obtain sufficient quantities

Source: APPLE COMPUTER INC, 10-Q, February 03, 2006

from the original source, or to identify and obtain sufficient quantities from an alternative source. Continued availability of these components may be affected if producers were to decide to concentrate on the production of common components instead of components customized to meet the Company's requirements. Finally, significant portions of the Company's CPUs, logic boards, and assembled products are now manufactured by outsourcing partners, primarily in various parts of Asia. Although the Company works closely with its outsourcing partners on manufacturing schedules, the Company's operating results could be adversely affected if its outsourcing partners were unable to meet their production obligations.

Long–Term Supply Agreements

During the first quarter of 2006, the Company entered into long–term supply agreements with Hynix Semiconductor, Inc., Intel Corporation, Micron Technology, Inc., Samsung Electronics Co., Ltd., and Toshiba Corporation to secure supply of NAND flash memory through calendar year 2010. As part of these agreements, the Company agreed to prepay $1.25 billion for flash memory components of which $750 million was paid during the first quarter of 2006 and the remaining $500 million was paid in the second quarter of 2006. These prepayments will be applied to inventory purchases made over the life of each respective agreement.

Contingencies

The Company is subject to certain other legal proceedings and claims that have arisen in the ordinary course of business and have not been fully adjudicated. In the opinion of management, the Company does not have a potential liability related to any current legal proceedings and claims that would individually or in the aggregate have a material adverse effect on its financial condition, liquidity, or results of operations. However, the results of legal proceedings cannot be predicted with certainty. Should the Company fail to prevail in any of these legal matters or should several of these legal matters be resolved against the Company in the same reporting period, the operating results of a particular reporting period could be materially adversely affected.

Production and marketing of products in certain states and countries may subject the Company to environmental and other regulations including, in some instances, the requirement to provide customers the ability to return product at the end of its useful life, and place responsibility for environmentally safe disposal or recycling with the Company. Such laws and regulations have recently been passed in several jurisdictions in which the Company operates including various European Union member countries, Japan and certain states within the U.S. Although the Company does not anticipate any material adverse effects in the future based on the nature of its operations and the thrust of such laws, there is no assurance that such existing laws or future laws will not have a material adverse effect on the Company's financial condition, liquidity, or results of operations.

Note 8 – Segment Information and Geographic Data

In accordance with SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*, the Company reports segment information based on the "management" approach. The management approach designates the internal reporting used by management for making decisions and assessing performance as the source of the Company's reportable segments.

The Company manages its business primarily on a geographic basis. The Company's reportable operating segments are comprised of the Americas, Europe, Japan, and Retail. The Americas, Europe, and Japan reportable segments do not include activities related to the Retail segment. The Americas segment includes both North and South America. The Europe segment includes European countries as well as the Middle East and Africa. The Retail segment operates Apple–owned retail stores in the U.S., Canada, Japan, and the U.K. Other operating segments include Asia–Pacific, which includes Australia and Asia except for Japan, and the Company's subsidiary, FileMaker, Inc. Each reportable geographic operating segment provides similar hardware and software products and similar services, and the accounting policies of the various segments are the same as those described in the Company's 2005 Form 10–K in Note 1, "Summary of Significant Accounting Policies," except as described below for the Retail segment.

The Company evaluates the performance of its operating segments based on net sales. The Retail segment's performance is also evaluated based on operating income. Net sales for geographic segments are generally based on the location of the customers. Operating income for each segment includes net sales to third parties, related cost of sales, and operating expenses directly attributable to the segment. Operating income for each segment excludes other income and expense and certain expenses that are managed outside the operating segments. Costs excluded from segment operating income include various corporate expenses, manufacturing costs and variances not included in

Source: APPLE COMPUTER INC, 10-Q, February 03, 2006

standard costs, income taxes, and various nonrecurring charges. Corporate expenses include research and development, corporate marketing expenses, manufacturing costs and variances not included in standard costs, stock-based compensation expense, and other separately managed general and administrative expenses including certain corporate expenses associated with support of the Retail segment. The Company does not include intercompany transfers between segments for management reporting purposes. Segment assets exclude corporate assets. Corporate assets include cash, short-term and long-term investments, manufacturing facilities, miscellaneous corporate infrastructure, goodwill and other acquired intangible assets, and retail store construction-in-progress that is not subject to depreciation. Except for the Retail segment, capital expenditures for long-lived assets are not reported to management by segment. Capital expenditures by the Retail segment were $40 million and $33 million during the first quarters of 2006 and 2005, respectively.

Operating income for all segments, except Retail, includes cost of sales at manufacturing standard cost, other cost of sales, related sales and marketing costs, and certain general and administrative costs. This measure of operating income, which includes manufacturing profit, provides a comparable basis for comparison between the Company's various geographic segments. Certain manufacturing expenses and related adjustments not included in segment cost of sales, including variances between standard and actual manufacturing costs and the mark-up above standard cost for product supplied to the Retail segment, are included in corporate expenses.

Management assesses the operating performance of the Retail segment differently than it assesses the operating performance of the Company's geographic segments. The Retail segment revenue and operating income is intended to depict a measure comparable to that of the Company's major channel partners in the U.S. operating retail stores so the Company can evaluate the Retail segment performance as if it were a channel partner. Therefore, the Company makes three significant adjustments to the Retail segment for management reporting purposes that are not included in the results of the Company's other segments.

First, the Retail segment's operating income includes cost of sales for Apple products at an amount normally charged to major channel partners in the U.S. operating retail stores, less the cost of sales programs and incentives provided to those channel partners and the Company's cost to support those partners. For the first quarter of 2006 and 2005, this resulted in the recognition of additional cost of sales above standard cost by the Retail segment and an offsetting benefit to corporate expenses of approximately $199 million and $99 million, respectively.

Second, the Company's service and support contracts are transferred to the Retail segment at the same cost as that charged to the Company's major retail channel partners in the U.S., resulting in a measure of revenue and gross margin for those items that is comparable between the Company's Retail stores and those retail channel partners. The Retail segment recognizes the full amount of revenue and cost of sales of the Company's service and support contracts at the time of sale. Because the Company has not yet earned the revenue or incurred the costs associated with the sale of these contracts, an offset to these amounts is recognized in other operating segments' net sales and cost of sales. For the first quarter of 2006, this resulted in the recognition of net sales and cost of sales by the Retail segment, with corresponding offsets in other operating segments, of $38 million and $25 million, respectively. For the first quarter of 2005, the net sales and cost of sales recognized by the Retail segment for sales of service and support contracts were $19 million and $13 million, respectively.

Third, the Company has opened seven high profile stores in New York; Los Angeles; Chicago; San Francisco; Tokyo, Japan; Osaka, Japan; and London, England as of December 31, 2005. These high profile stores are larger than the Company's typical retail stores and were designed to further promote brand awareness and provide a venue for certain corporate sales and marketing activities, including corporate briefings. As such, the Company allocates certain operating expenses associated with these stores to corporate marketing expense to reflect the estimated benefit realized Company-wide. The allocation of these operating costs is based on the amount incurred for a high profile store in excess of that incurred by a more typical Company retail location. Expenses allocated to corporate marketing resulting from the operations of these stores were $7.6 million and $6.9 million in the first quarters of 2006 and 2005, respectively.

Source: APPLE COMPUTER INC, 10-Q, February 03, 2006

Summary information by operating segment is as follows (in millions):

	Three Months Ended	
	12/31/05	12/25/04
Americas:		
Net sales	$ 2,700	$ 1,637
Operating income	$ 436	$ 202
Europe:		
Net sales	$ 1,242	$ 847
Operating income	$ 174	$ 133
Japan:		
Net sales	$ 355	$ 185
Operating income	$ 53	$ 21
Retail:		
Net sales	$ 1,072	$ 561
Operating income	$ 90	$ 45
Other Segments (a):		
Net sales	$ 380	$ 260
Operating income	$ 66	$ 37

(a) Other Segments consists of Asia–Pacific and FileMaker.

A reconciliation of the Company's segment operating income to the consolidated financial statements is as follows (in millions):

	Three Months Ended	
	12/31/05	12/25/04
Segment operating income	$ 819	$ 438
Retail manufacturing margin (b)	199	99
Stock–based compensation expense	(44)	(10)
Corporate expenses, net (c)	(224)	(124)
Total operating income	$ 750	$ 403

(b) Represents the excess of the Retail segment's cost of sales over the Company's standard cost of sales for products sold through the Retail segment.

(c) Corporate expenses include research and development, corporate marketing expenses, manufacturing costs and variances not included in standard costs, and other separately managed general and administrative expenses including certain corporate expenses associated with support of the Retail segment.

Note 9 — Related Party Transactions and Certain Other Transactions

In March 2002, the Company entered into a Reimbursement Agreement with its CEO, Mr. Steven P. Jobs, for the reimbursement of expenses incurred by Mr. Jobs in the operation of his private plane when used for Apple business. The Reimbursement Agreement became effective for expenses incurred by Mr. Jobs for Apple business purposes since he took delivery of the plane in May 2001. The Company did not recognize any expense pursuant to the Reimbursement Agreement during the first quarter of 2006. The Company recognized $419,000 in expenses pursuant to the Reimbursement Agreement during the first quarter of 2005. All expenses recognized pursuant to the Reimbursement Agreement have been included in selling, general, and administrative expenses in the Condensed Consolidated Statements of Operations.

In the first quarter of 2006, the Company entered into an agreement with Pixar to sell certain of Pixar's short films on the iTunes Music Store. Mr. Steven P. Jobs, the Company's CEO is also the CEO, Chairman, and a large shareholder of Pixar. During the first quarter of 2006, the Company recognized total expense under this arrangement of approximately $712,000.

Source: APPLE COMPUTER INC, 10-Q, February 03, 2006

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

This section and other parts of this Form 10-Q contain forward-looking statements that involve risks and uncertainties. Forward-looking statements can be identified by words such as "anticipates," "expects," "believes," "plans," "predicts," and similar terms. Forward-looking statements are not guarantees of future performance and the Company's actual results may differ significantly from the results discussed in the forward-looking statements. Factors that might cause such differences include, but are not limited to, those discussed in the subsection entitled "Factors That May Affect Future Results and Financial Condition" below. The following discussion should be read in conjunction with the 2005 Form 10-K and the condensed consolidated financial statements and notes thereto included elsewhere in this Form 10-Q. All information is based on the Company's fiscal calendar. Unless otherwise stated, references in this report to particular years or quarters refer to the Company's fiscal years ended in September and the associated quarters of those fiscal years. The Company assumes no obligation to revise or update any forward-looking statements for any reason, except as required by law.

Available Information

The Company's Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and amendments to reports filed pursuant to Sections 13(a) and 15(d) of the Securities Exchange Act of 1934, as amended, are available on its website at http://www.apple.com/investor when such reports are available on the Securities and Exchange Commission (SEC) website. The public may read and copy any materials filed by the Company with the SEC at the SEC's Public Reference Room at 100 F Street, NE, Room 1580, Washington, DC 20549. The public may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. The SEC maintains an Internet site that contains reports, proxy and information statements and other information regarding issuers that file electronically with the SEC at http://www.sec.gov. The contents of these websites are not incorporated into this filing. Further, the Company's references to the URLs for these websites are intended to be inactive textual references only.

Executive Overview

The Company designs, manufactures, and markets personal computers and related software, services, peripherals, and networking solutions. The Company also designs, develops, and markets a line of portable digital music players along with related accessories and services including the online distribution of third-party music, audio books, music videos, short films, and television shows. The Company's products and services include the Macintosh line of desktop and notebook computers, the iPod digital music player, the Xserve G5 server and Xserve RAID storage products, a portfolio of consumer and professional software applications, the Mac OS X operating system, the iTunes Music Store, a portfolio of peripherals that support and enhance the Macintosh and iPod product lines, and a variety of other service and support offerings. The Company sells its products worldwide through its online stores, its own retail stores, its direct sales force, and third-party wholesalers, resellers, and value added resellers. In addition, the Company sells a variety of third-party Macintosh compatible products, including computer printers and printing supplies, storage devices, computer memory, digital camcorders and still cameras, personal digital assistants, and various other computing products and supplies through its online and retail stores. The Company sells to education, consumer, creative professional, business, and government customers. A further description of the Company's products may be found below and in Part I, Item 1 of the Company's 2005 Form 10-K.

The Company's business strategy leverages its ability, through the design and development of its own operating system, hardware, and many software applications and technologies, to bring to its customers around the world compelling new products and solutions with superior ease-of-use, seamless integration, and innovative industrial design.

The Company participates in several highly competitive markets, including personal computers with its Macintosh line of computers, consumer electronics with its iPod line of digital music players, and distribution of third-party digital content through its online iTunes Music Store. While the Company is widely recognized as an innovator in the personal computer and consumer electronic markets as well as a leader in the emerging market for distribution of digital content, these are all highly competitive markets that are subject to aggressive pricing and increased competition. To remain competitive, the Company believes that increased investment in research and development (R&D) and marketing and advertising is necessary to maintain and extend its position in the markets where it competes. The Company's R&D spending is focused on delivering timely updates and enhancements to its existing line of personal computers, displays, operating systems, software applications, and portable music players; developing new digital lifestyle consumer and professional software applications; and investing in new product areas

Source: APPLE COMPUTER INC, 10-Q, February 03, 2006

such as rack-mount servers, RAID storage systems, and wireless technologies. The Company also believes investment in marketing and advertising programs is critical to increasing product and brand awareness.

In June 2005, the Company announced its plan to begin using Intel microprocessors in its Macintosh computers and in January 2006 announced the new iMac® and MacBook™ Pro, which are the first Macintosh computers to run on Intel microprocessors. The Company expects to complete the transition of all of its Macintosh computers to Intel microprocessors by the end of calendar year 2006. There are potential risks and uncertainties that may occur during this transition, which are further discussed under the heading "Factors That May Affect Future Results and Financial Condition."

The Company utilizes a variety of direct and indirect distribution channels. The Company believes that sales of its innovative and differentiated products are enhanced by knowledgeable salespersons who can convey the value of the hardware, software, and peripheral integration, demonstrate the unique digital lifestyle solutions that are available only on Macintosh computers, and demonstrate the compatibility of the Macintosh with the Windows platform and networks. The Company further believes that providing a high-quality sales and after-sales support experience is critical to attracting and retaining customers. To ensure a high-quality buying experience for its products in which service and education are emphasized, the Company has expanded and improved its distribution capabilities by opening its own retail stores in the U.S. and internationally. The Company had 136 stores open as of January 31, 2006.

The Company also staffs selected third-party stores with the Company's own employees and contractors in various geographic locations including the U.S., Europe, Japan, and Australia to improve the buying experience through reseller channels. Additionally, the Company sells to customers directly through its online stores around the world.

To improve access to the iPod product line, the Company has continued to expand the number of distribution points where iPods are sold. The iPod product line can be purchased in certain department stores, member-only warehouse stores, large retail chains, and specialty retail stores, as well as through the channels listed above.

Critical Accounting Policies and Estimates

The preparation of financial statements and related disclosures in conformity with U.S. generally accepted accounting principles and the Company's discussion and analysis of its financial condition and results of operations require the Company's management to make judgments, assumptions, and estimates that affect the amounts reported in its condensed consolidated financial statements and accompanying notes. Note 1 of the Notes to Consolidated Financial Statements in the Company's 2005 Form 10-K describes the significant accounting policies and methods used in the preparation of the Company's consolidated financial statements. Management bases its estimates on historical experience and on various other assumptions it believes to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities. Actual results may differ from these estimates and such differences may be material.

Management believes the Company's critical accounting policies and estimates are those related to revenue recognition, allowance for doubtful accounts, inventory valuation and inventory purchase commitments, warranty costs, stock-based compensation, and income taxes. Management believes these policies to be critical because they are both important to the portrayal of the Company's financial condition and results, and they require management to make judgments and estimates about matters that are inherently uncertain. The Company's senior management has reviewed these critical accounting policies and related disclosures with the Audit and Finance Committee of the Company's Board of Directors.

Revenue Recognition

Net sales consist primarily of revenue from the sale of hardware, software, peripherals, digital content, and service and support contracts. The Company recognizes revenue pursuant to applicable accounting standards, including Statement of Position (SOP) No. 97-2, *Software Revenue Recognition*, as amended, and SEC Staff Accounting Bulletin (SAB) No. 104, *Revenue Recognition.*

The Company recognizes revenue when persuasive evidence of an arrangement exists, delivery has occurred, the sales price is fixed or determinable, and collection is probable. Product is considered delivered to the customer once it has been shipped, and title and risk of loss have been transferred. For most of the Company's product sales, these criteria are met at the time the product is shipped. For online sales to individuals, for some sales to education

Source: APPLE COMPUTER INC, 10-Q, February 03, 2006

customers in the U.S., and for certain other sales, the Company defers revenue until the customer receives the product because the Company legally retains a portion of the risk of loss on these sales during transit. If at the outset of an arrangement the Company determines the arrangement fee is not, or is presumed not to be, fixed or determinable, revenue is deferred and subsequently recognized as amounts become due and payable.

The Company records reductions to revenue for estimated commitments related to price protection and for customer incentive programs, including reseller and end-user rebates, and other sales programs and volume-based incentives. The estimated cost of these programs is accrued as a reduction to revenue in the period the Company has sold the product and committed to the relevant program. The Company also records reductions to revenue for expected future product returns based on the Company's historical experience. Future market conditions and product transitions may require the Company to increase customer incentive programs and incur incremental price protection obligations that could result in additional reductions to revenue at the time such programs are offered. Additionally, certain customer incentive programs require management to estimate the number of customers who will actually redeem the incentive based on historical experience and the specific terms and conditions of particular incentive programs. If a greater than estimated proportion of customers redeem such incentives, the Company would be required to record additional reductions to revenue, which could have a material adverse impact on the Company's results of operations.

Allowance for Doubtful Accounts

The Company distributes its products through third-party resellers and directly to certain education, consumer, and commercial customers. The Company generally does not require collateral from its customers. However, when possible the Company does attempt to limit credit risk on trade receivables with credit insurance for certain customers in Latin America, Europe, and Asia and by arranging with third-party financing companies to provide flooring arrangements and other loan and lease programs to the Company's direct customers. These credit-financing arrangements are directly between the third-party financing company and the end customer. As such, the Company generally does not assume any recourse or credit risk sharing related to any of these arrangements. However, considerable trade receivables that are not covered by collateral, third-party flooring arrangements, or credit insurance are outstanding with the Company's distribution and retail channel partners.

The allowance for doubtful accounts is based on management's assessment of the collectibility of specific customer accounts and includes consideration of the credit worthiness and financial condition of those specific customers. The Company records an allowance to reduce the specific receivables to the amount that is reasonably believed to be collectible. The Company also records an allowance for all other trade receivables based on multiple factors including historical experience with bad debts, the general economic environment, the financial condition of the Company's distribution channels, and the aging of such receivables. If there is a deterioration of a major customer's financial condition, if the Company becomes aware of additional information related to the credit worthiness of a major customer, or if future actual default rates on trade receivables in general differ from those currently anticipated, the Company may have to adjust its allowance for doubtful accounts, which would affect earnings in the period the adjustments are made.

Inventory Valuation and Inventory Purchase Commitments

The Company must order components for its products and build inventory in advance of product shipments. The Company records a write-down for inventories of components and products, including third-party products held for resale, which have become obsolete or are in excess of anticipated demand or net realizable value. The Company performs a detailed review of inventory each fiscal quarter that considers multiple factors including demand forecasts, product life cycle status, product development plans, current sales levels, and component cost trends. The personal computer and consumer electronic industries are subject to a rapid and unpredictable pace of product and component obsolescence and demand changes. If future demand or market conditions for the Company's products are less favorable than forecasted or if unforeseen technological changes negatively impact the utility of component inventory, the Company may be required to record additional write-downs which would negatively affect gross margins in the period when the write-downs are recorded.

The Company accrues necessary reserves for cancellation fees related to component orders that have been cancelled. Consistent with industry practice, the Company acquires components through a combination of purchase orders, supplier contracts, and open orders based on projected demand information. These commitments typically cover the Company's requirements for periods ranging from 30 to 150 days. If there is an abrupt and substantial decline in demand for one or more of the Company's products or an unanticipated change in technological requirements for any

Source: APPLE COMPUTER INC, 10-Q, February 03, 2006

of the Company's products, the Company may be required to record additional reserves for cancellation fees that would negatively affect gross margins in the period when the cancellation fees are identified.

Warranty Costs
The Company provides currently for the estimated cost for product warranties at the time the related revenue is recognized based on historical and projected warranty claim rates, historical and projected cost-per-claim, and knowledge of specific product failures that are outside of the Company's typical experience. Each quarter, the Company reevaluates its estimates to assess the adequacy of its recorded warranty liabilities considering the size of the installed base of products subject to warranty protection and adjusts the amounts as necessary. If actual product failure rates or repair costs differ from estimates, revisions to the estimated warranty liability would be required and could negatively affect the Company's results of operations.

Stock-Based Compensation
The Company accounts for stock-based compensation in accordance with Statement of Financial Accounting Standards (SFAS) No. 123R, *Share-Based Payment.* Under the provisions of SFAS No. 123R, stock-based compensation cost is estimated at the grant date based on the award's fair-value as calculated by the Black-Scholes-Merton (BSM) option-pricing model and is recognized as expense ratably over the requisite service period. The BSM model requires various highly judgmental assumptions including volatility, forfeiture rates, and expected option life. If any of the assumptions used in the BSM model change significantly, stock-based compensation expense may differ materially in the future from that recorded in the current period.

Income Taxes
The Company records a tax provision for the anticipated tax consequences of the reported results of operations. In accordance with SFAS No. 109, *Accounting for Income Taxes*, the provision for income taxes is computed using the asset and liability method, under which deferred tax assets and liabilities are recognized for the expected future tax consequences of temporary differences between the financial reporting and tax bases of assets and liabilities, and for operating losses and tax credit carryforwards. Deferred tax assets and liabilities are measured using the currently enacted tax rates that apply to taxable income in effect for the years in which those tax assets are expected to be realized or settled. The Company records a valuation allowance to reduce deferred tax assets to the amount that is believed more likely than not to be realized. The Company is currently evaluating the repatriation provisions of the American Jobs Creation Act of 2004, which, if implemented by the Company, would affect the Company's tax provision and deferred tax assets and liabilities.

Management believes it is more likely than not that forecasted income, including income that may be generated as a result of certain tax planning strategies, together with the tax effects of the deferred tax liabilities, will be sufficient to fully recover the remaining deferred tax assets. In the event that all or part of the net deferred tax assets are determined not to be realizable in the future, an adjustment to the valuation allowance would be charged to earnings in the period such determination is made. Similarly, if the Company subsequently realizes deferred tax assets that were previously determined to be unrealizable, the respective valuation allowance would be reversed, resulting in a positive adjustment to earnings or a decrease in goodwill in the period such determination is made. In addition, the calculation of tax liabilities involves significant judgment in estimating the impact of uncertainties in the application of complex tax laws. Resolution of these uncertainties in a manner inconsistent with management's expectations could have a material impact on the Company's results of operations and financial position.

Products
The Company offers a range of personal computing products including desktop and notebook personal computers, related devices and peripherals, and various third-party hardware products. In addition, the Company offers software products including Mac OS® X, the Company's proprietary operating system software for the Macintosh®; server software and related solutions; professional application software; and consumer, education and business oriented application software. The Company also designs, develops and markets to Macintosh and Windows users its line of iPod® digital music players along with related accessories and services including the online distribution of third-party music through the Company's iTunes Music Store®. A detailed discussion of the Company's products may be found in the 2005 Form 10-K. Certain newly introduced products and/or upgrades to existing products are discussed below.

Source: APPLE COMPUTER INC, 10-Q, February 03, 2006

In January 2006, the Company announced the new iMac® and MacBook™ Pro, which are the first Macintosh computers to run on Intel microprocessors. The iMac and MacBook Pro feature the Company's new translation technology, Rosetta™, which allows most PowerPC-based Macintosh applications to run on these new Intel-based Macintosh computers.

iMac®

The Company's new iMac featuring the Intel Core Duo processor is available in a 17-inch widescreen LCD display with a 1.83 GHz processor and 160GB Serial ATA hard drive. The iMac is also available in a 20-inch widescreen LCD display with a 2.0 GHz processor and 250GB Serial ATA hard drive. Both models include a built-in iSight™ video camera for video conferencing, Front Row™ with the Apple Remote, 512 MB of 667 MHz DDR2 SDRAM expandable to 2GB, 8x SuperDrive™ with double-layer support, and PCI Express-based ATI Radeon X1600 with 128MB GDDR3 memory. Every new iMac comes with iLife® '06.

MacBook™ Pro

The Company's new MacBook Pro featuring the Intel Core Duo processor is expected to begin shipping in February 2006. The MacBook Pro features an aluminum enclosure that is one-inch thin, weighs 5.6 pounds, includes a built-in iSight video camera for video conferencing, Front Row with the Apple Remote, iLife '06, two USB 2.0 ports, one FireWire® 400 port, a gigabit Ethernet port, built-in AirPort Extreme® wireless networking and Bluetooth 2.0+EDR, and a slot-load SuperDrive. The new MacBook Pro also features Apple's new patent-pending MagSafe™ magnetic power connector.

iPod® Radio Remote

In January 2006, the Company announced iPod Radio Remote, a wired remote control with FM radio capabilities. The iPod Radio Remote allows users to skip tracks, adjust the volume of their iPods, and listen to FM radio stations while displaying station and song information on their iPod screens.

iLife® '06

In January 2006, the Company introduced iLife '06, an upgrade to its consumer-oriented digital lifestyle application suite, which features iWeb™, iPhoto® 6, iMovie® HD6, iDVD® 6, and GarageBand™ 3.

iWeb™ is a new application in the iLife'06 suite. iWeb allows users to create online photo albums, blogs and podcasts and customize websites using editing tools and pre-designed templates.

iPhoto® 6 adds new photo management and editing features, supports up to 250,000 photos, and introduces Photocasting™. Photocasting allows .Mac users to share and automatically update photo albums over the Internet with anyone who uses a Macintosh or Windows-based PC.

iMovie® HD 6 now includes new real-time effects that take advantage of Core Video technology, which uses the computer's video card's graphics processing unit to deliver hardware acceleration to quickly preview video effects. iMovie 6 also provides a solution to make video podcasts, which can be published with iWeb, and includes audio enhancement tools and sound effects.

iDVD® 6 now allows users to take content shot with HDV and widescreen DV cameras and author custom DVDs with widescreen menus, movies, and high resolution slideshows. iDVD 6 features 10 new Apple-designed menu themes in both widescreen (16:9) and standard (4:3) formats.

GarageBand™ 3 now allows users to record, produce, and publish through iWeb their own podcasts, including artwork, sound effects, and music jingles.

iWork™ '06

In January 2006, the Company introduced iWork '06, a new version of the Company's suite of productivity software designed to help users create, present, and publish documents and presentations. iWork '06 includes Pages® 2 and Keynote™ 3.

Pages® 2 features mail merge with Mac OS® X Address Book, which allows users to personalize documents by dragging and dropping individual contacts into documents using templates with predefined

Source: APPLE COMPUTER INC, 10-Q, February 03, 2006

fields. Pages 2 also features new templates for newsletters, flyers, posters, school reports, scrapbooks, brochures, business proposals, and invoices. Pages 2 allows users to insert tables that have basic calculation functionality within any document and users can export their Pages 2 document to other formats.

Keynote™ 3 offers additional ways to create presentations and interactive slideshows. It features new cinematic transitions including vertical and horizontal blinds, revolving door, and swoosh. A new view mode, Light Table, allows users to view an entire presentation and reorganize slides using drag and drop.

Source: APPLE COMPUTER INC, 10-Q, February 03, 2006

Net Sales

The first quarter of 2006 spanned 14 weeks while the first quarter of 2005 spanned 13 weeks. This additional week is added to the first fiscal quarter approximately every six years to realign fiscal quarters with calendar quarters.

Net sales and Macintosh unit sales by operating segment and net sales and unit sales by product follow (net sales in millions and unit sales in thousands):

	Three Months Ended		
	12/31/05	12/25/04	Change
Net Sales by Operating Segment:			
Americas net sales	$ 2,700	$ 1,637	65%
Europe net sales	1,242	847	47%
Japan net sales	355	185	92%
Retail net sales	1,072	561	91%
Other Segments net sales (a)	380	260	46%
Total net sales	$ 5,749	$ 3,490	65%
Unit Sales by Operating Segment:			
Americas Macintosh unit sales	515	476	8%
Europe Macintosh unit sales	387	320	21%
Japan Macintosh unit sales	81	64	27%
Retail Macintosh unit sales	193	119	62%
Other Segments Macintosh unit sales (a)	78	67	16%
Total Macintosh unit sales	1,254	1,046	20%
Net Sales by Product:			
Desktops (b)	$ 912	$ 1,001	(9)%
Portables (c)	812	604	34%
Total Macintosh net sales	1,724	1,605	7%
iPod	2,906	1,211	140%
Other music related products and services (d)	491	177	177%
Peripherals and other hardware (e)	303	284	7%
Software, service, and other sales (f)	325	213	53%
Total net sales	$ 5,749	$ 3,490	65%
Unit Sales by Product:			
Desktops (b)	667	623	7%
Portables (c)	587	423	39%
Total Macintosh unit sales	1,254	1,046	20%
Net sales per Macintosh unit sold (g)	$ 1,375	$ 1,534	(10)%
iPod unit sales	14,043	4,580	207%
Net sales per iPod unit sold (h)	$ 207	$ 264	(22)%

Notes:

(a) Other Segments include Asia Pacific and FileMaker.
(b) Includes iMac, eMac, Mac mini, Power Mac, and Xserve product lines.
(c) Includes iBook and PowerBook product lines.
(d) Consists of iTunes Music Store sales, iPod services, and Apple-branded and third-party iPod accessories.
(e) Includes sales of Apple-branded and third-party displays, wireless connectivity and networking solutions, and other hardware accessories.
(f) Includes sales of Apple-branded operating system software, application software, third-party software, AppleCare, and Internet services.
(g) Derived by dividing total Macintosh net sales by total Macintosh unit sales.
(h) Derived by dividing total iPod net sales by total iPod unit sales.

Source: APPLE COMPUTER INC, 10-Q, February 03, 2006

Net sales during the first quarter of 2006 increased 65% or $2.3 billion from the first quarter of 2005. The increase was due in part to the fact that the first quarter of 2006 spanned 14 weeks while the first quarter of 2005 spanned 13 weeks. Several other factors contributed to this increase including the following:

- Net sales of iPods rose $1.7 billion or 140% during the first quarter of 2006 compared to the first quarter of 2005. Unit sales of iPods totaled 14.0 million in the first quarter of 2006, which represents an increase of 207% from the 4.6 million iPod units sold in the first quarter of 2005. Strong sales of iPods during the first quarter of 2006 continued to be experienced by all of the Company's operating segments and were driven by strong demand for the newest version of the iPod with video playing capabilities introduced in October 2005, the release of the iPod nano in September 2005, and expansion of the iPod's distribution network. Net sales per iPod unit sold decreased 22% primarily due to the introduction of the lower priced iPod shuffle in January 2005 and a shift in sales towards the lower-priced iPod nano.

- Net sales of other music related products and services increased $314 million or 177% during the first quarter of 2006 compared to the first quarter of 2005 primarily due to increased net sales from the iTunes Music Store and of iPod services and accessories. The year-over-year increase in sales from the iTunes Music Store relates to significant growth in U.S. sales, the expansion of the iTunes Music Store to seven additional countries by the end of the first quarter of 2006 from the first quarter of 2005, including Japan and Australia, and the introduction of video sales on the iTunes Music Store in October 2005. The Company has also experienced strong growth in sales of both Apple-branded and third-party iPod accessories and services, consistent with the increase in overall iPod unit sales for the first quarter of 2006.

- The Retail segment's net sales grew to $1.1 billion during the first quarter of 2006 from $561 million during the first quarter of 2005, a 91% increase, while Retail segment Macintosh unit sales increased 62%. These increases are largely attributable to the increase in total stores from 101 stores at the end of the first quarter of 2005 to 135 stores at the end of the first quarter of 2006, as well as a 41% year-over-year increase in average revenue per store.

- Macintosh net sales increased $119 million or 7% during the first quarter of 2006 compared to the first quarter of 2005. Macintosh unit sales increased by 208,000 units or 20% during the first quarter of 2006 compared to the first quarter of 2005. The increases in Macintosh net sales and unit sales were driven by higher sales of portable products in all of the Company's operating segments. Net sales and unit sales of the Company's portable products increased 34% and 39%, respectively. The increase in Macintosh portable net sales was partially offset by a decrease in Macintosh desktop net sales of 9%, while Macintosh desktop unit sales increased by 7% year-over-year. The year-over-year increase in desktop unit sales with a corresponding decrease in desktop net sales was primarily due to the introduction of the Mac mini in the second quarter of 2005. The Mac mini's starting price of $499 is significantly lower than the starting prices of the Company's other desktop products and contributed to a decrease in net sales per Macintosh unit sold of 10% year-over-year.

- Net sales of peripherals and other hardware rose by 7% during the first quarter of 2006 compared to the first quarter of 2005 primarily due to an increase in net sales of RAID storage, iSight digital video cameras, printers, and other hardware accessories.

- U.S. education channel net sales increased by approximately 16% during the first quarter of 2006 compared to the first quarter of 2005, while Macintosh unit sales were relatively flat compared to the first quarter of 2005. Net sales from the higher education market grew 31% in the first quarter of 2006 compared to the first quarter of 2005 due to strong iPod sales, as well as increases in Macintosh portable products and Apple-branded software sales. Net sales were relatively flat for K-12 year-over-year.

- Net sales of software, service, and other sales rose $112 million or 53% during the first quarter of 2006 compared to the first quarter of 2005. This growth was primarily attributable to increased net sales in AppleCare Protection Plan (APP) extended service and support contracts, Mac OS X, and third-party software.

Source: APPLE COMPUTER INC, 10-Q, February 03, 2006

Segment Operating Performance

The Company manages its business primarily on a geographic basis. The Company's reportable operating segments are comprised of the Americas, Europe, Japan, and Retail. The Americas, Europe, and Japan reportable segments do not include activities related to the Retail segment. The Americas segment includes both North and South America. The Europe segment includes European countries as well as the Middle East and Africa. The Retail segment operated Apple–owned retail stores in the U.S., Canada, Japan, and the U.K. during the first quarter of 2006. Each reportable geographic operating segment provides similar hardware and software products and similar services. Further information regarding the Company's operating segments may be found in Part I, Item 1 of this Form 10–Q in the Notes to Condensed Consolidated Financial Statements at Note 8, "Segment Information and Geographic Data."

Americas

Net sales in the Americas segment during the first quarter of 2006 increased $1.1 billion or 65% compared to the first quarter of 2005, while Macintosh unit sales increased 8% year–over–year. The increase in net sales during the first quarter of 2006 was primarily attributable to the significant year–over–year increase in iPod sales, sales of other music related products and services, sales of portable Macintosh systems, and sales of software, service, and other sales. These increases were partially offset by a 18% decrease in desktop net sales year–over–year. During both the first quarters of 2006 and 2005, the Americas segment represented approximately 47% of the Company's total net sales. The Company experienced a year–over–year increase in its U.S. education channel net sales of 16% compared to the first quarter of 2005 due to strong iPod sales, as well as increases in Macintosh portable products and Apple–branded software sales.

Europe

Net sales in Europe increased $395 million or 47% during the first quarter of 2006 as compared to the same quarter in 2005. Total Macintosh unit sales in Europe increased 21% on a year–over–year basis. Consistent with the Americas segment, Europe experienced strong sales of iPods, portable products, and other music related products and services. The Europe segment also experienced strong sales of Apple–branded and third–party displays and other hardware accessories. These increases were offset by a 9% decrease in desktop net sales on a year–over–year basis.

Japan

Japan's net sales increased $170 million or 92% during the first quarter of 2006. Japan experienced increased net sales in iPod, portable products, and other music related products and services. iPod net sales increased by 277% and portable net sales increased by 27% on a year–over–year basis during the first quarter of 2006 compared to the first quarter of 2005. The increases in net sales of iPod and other music related products and services are believed to be partly attributable to the introduction of the iTunes Music Store in Japan in the fourth quarter of 2005 and an increase in marketing and advertising activities during the first quarter of 2006.

Retail

During the first quarter of 2006, the Company opened 11 new retail stores. The Company had 135 retail stores open at the end of the first quarter of 2006 compared to 101 stores at the end of the first quarter of 2005. During the first quarter of 2006, the Retail segment's net sales grew to $1.1 billion as compared to $561 million in the first quarter of 2005, a 91% increase. With an average of 129 stores open during the quarter, average quarterly revenue per store increased 41% to $8.3 million in the first quarter of 2006, up from $5.9 million in the first quarter of 2005. The increase in average revenue per store was primarily due to strong sales of iPods, other music related products and services, and Macintosh portable products.

As measured by the Company's operating segment reporting, the Retail segment reported a profit of $90 million during the first quarter of 2006 compared to a profit of $45 million during the first quarter of 2005. This improvement in profitability is primarily attributable to the segment's year–over–year increase in average quarterly revenue per store, the impact of opening 34 new stores, and the segment's year–over–year increase in net sales, which resulted in higher leverage on occupancy, depreciation, and other fixed costs.

Expansion of the Retail segment has required and will continue to require a substantial investment in fixed assets and related infrastructure, operating lease commitments, personnel, and other operating expenses. Capital expenditures associated with the Retail segment since its inception totaled $569 million through the end of the first quarter of 2006, of which $40 million was incurred during the first quarter of 2006.

Source: APPLE COMPUTER INC, 10-Q, February 03, 2006

As of December 31, 2005, the Retail segment had approximately 4,739 full-time equivalent employees and had outstanding lease commitments associated with retail store space and related facilities of $705 million.

Gross Margin

Gross margin for the three months ended December 31, 2005 and December 25, 2004 was as follows (in millions, except gross margin percentages):

	Three Months Ended	
	12/31/05	12/25/04
Net sales	$ 5,749	$ 3,490
Cost of sales	4,185	2,494
Gross margin	$ 1,564	$ 996
Gross margin percentage	27.2%	28.5%

Gross margin percentage for the first quarter of 2006 was 27.2% compared to 28.5% for the first quarter of 2005. The year-over-year decrease in gross margin percentage during the first quarter of 2006 was primarily due to a relative increase in lower margin products, particularly the iPod product family and music-related services. Additionally, gross margins on Macintosh net sales were lower on a year-over-year basis primarily due to reductions in average selling prices from the first quarter of 2005.

The Company anticipates that its gross margin and the gross margin of the overall personal computer and consumer electronics industries will remain under pressure in light of price competition, especially for the iPod product line. The Company expects its gross margin percentage to increase slightly in the second quarter of 2006 primarily as a result of favorable costs of certain commodity components including LCD flat-panel displays, as well as a shift in the mix of revenue toward higher margin products.

The foregoing statements regarding the Company's expected gross margin and forecasted revenue for the second quarter of 2006 are forward-looking. Gross margin could differ from anticipated levels because of several factors, including certain of those set forth below in the subsection entitled "Factors That May Affect Future Results and Financial Condition." There can be no assurance that current gross margins will be maintained, targeted gross margin levels will be achieved, or current margins on existing individual products will be maintained.

Operating Expenses

Operating expenses for the three months ended December 31, 2005 and December 25, 2004 was as follows (in millions, except for percentages):

	Three Months Ended	
	12/31/05	12/25/04
Research and development	$ 182	$ 123
Percentage of net sales	3%	4%
Selling, general, and administrative expenses	$ 632	$ 470
Percentage of net sales	11%	13%

Research and Development (R&D)

Expenditures for R&D increased 48% or $59 million to $182 million in the first quarter of 2006 compared to $123 million in the first quarter of 2005 due primarily to an increase in R&D headcount in the current year to support expanded R&D activities, a $13 million increase in stock-based compensation expense recognized as R&D resulting from the adoption of SFAS No. 123R, and higher overall expenses due to the 14th week added to the first fiscal quarter of 2006 to realign the Company's fiscal quarters with calendar quarters. In addition, during the first quarter of 2005, the Company capitalized approximately $14.8 million of costs associated with the development of Mac OS X Tiger. No software development costs were capitalized during the first quarter of 2006. The decrease in R&D as a percentage of net sales to 3% in the first quarter of 2006 from 4% in the first quarter of 2005 is due to the significant increase of 65% in total net sales for the Company in the first quarter of 2006. The Company continues to believe that focused investments in R&D are critical to its future growth and competitive position in the marketplace and are directly related to timely development of new and enhanced products that are central to the Company's core business strategy. As such, the Company expects to make further investments in R&D to remain competitive.

Source: APPLE COMPUTER INC, 10-Q, February 03, 2006

Selling, General, and Administrative Expense (SG&A)
SG&A increased 34% or $162 million to $632 million in the first quarter of 2006 compared to $470 million in the first quarter of 2005. This increase is primarily due to higher direct and channel variable selling expenses resulting from the significant year-over-year increase in total net sales for the first quarter, the Company's continued expansion of its Retail segment in both domestic and international markets, a $16 million increase in stock-based compensation expense recognized as SG&A resulting from the adoption of SFAS No. 123R, a current year increase in discretionary spending on marketing and advertising, and the associated expenses with the 14th week added to the first fiscal quarter of 2006.

Other Income and Expense
Other income and expense for the three months ended December 31, 2005 and December 25, 2004 was as follows (in millions):

	Three Months Ended	
	12/31/05	12/25/04
Interest income	$ 88	$ 28
Other expense, net	(7)	(2)
Total other income and expense	$ 81	$ 26

Total other income and expense increased $55 million to $81 million during the first quarter of 2006 compared to $26 million in the first quarter of 2005. This increase is attributable primarily to higher cash and short-term investment balances and increasing investment yields resulting from higher market interest rates, and the 14th week added to the first fiscal quarter of 2006. The weighted-average interest rate earned by the Company on its cash, cash equivalents and short-term investments increased to 3.89% in the first quarter of 2006 from 1.93% in the first quarter of 2005.

Provision for Income Taxes
The Company's effective tax rate for the three months ended December 31, 2005 was approximately 32% compared with approximately 31% for the same period of 2005. The Company's effective rate for both periods differs from the statutory federal income tax rate of 35% due primarily to certain undistributed foreign earnings for which no U.S. taxes are provided because such earnings are intended to be indefinitely reinvested outside the U.S. The higher tax rate in the first three months of 2006 versus 2005 is primarily due to an overall increase in earnings as well as a greater mix of earnings in the U.S.

The Internal Revenue Service (IRS) has completed its field audit of the Company's federal income tax returns for all years prior to 2002 and proposed certain adjustments. Certain of these adjustments are being contested through the IRS Appeals Office. Substantially all IRS audit issues for these years have been resolved. In addition, the Company is subject to audits by state, local, and foreign tax authorities. Management believes that adequate provision has been made for any adjustments that may result from tax examinations. However, the outcome of tax audits cannot be predicted with certainty. Should any issues addressed in the Company's tax audits be resolved in a manner not consistent with management's expectations, the Company could be required to adjust its provision for income tax in the period such resolution occurs.

On October 22, 2004, the American Jobs Creation Act (AJCA) was signed into law. The AJCA includes a provision for the deduction of 85% of certain foreign earnings that are repatriated, as defined in the AJCA. The Company may elect to apply this provision to repatriations of qualifying earnings in fiscal year 2006. The Company is continuing to evaluate the effects of the repatriation provision and expects to complete the evaluation in fiscal year 2006. A maximum of $755 million may be eligible for repatriation under the reduced tax rate provided by AJCA. However, given the uncertainties and complexities of the repatriation provision and the Company's continuing evaluation, the Company has not yet determined the amount that may be repatriated or the related potential income tax effects of such repatriation.

Recent Accounting Pronouncements
In November 2005, the Financial Accounting Standards Board (FASB) issued FASB Staff Position (FSP) Nos. FAS 115-1 and FAS 124-1, *The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments*. FSP Nos. FAS 115-1 and FAS 124-1 amend SFAS No. 115, *Accounting for Certain Investments in*

Source: APPLE COMPUTER INC, 10-Q, February 03, 2006

Debt and Equity Securities, SFAS No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*, as well as APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*. This guidance nullifies certain requirements of EITF 03-1, *The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments*. FSP Nos. FAS 115-1 and FAS 124-1 include guidance for evaluating and recording impairment losses on debt and equity investments, as well as new disclosure requirements for investments that are deemed to not be other-than-temporarily impaired. FSP Nos. FAS 115-1 and FAS 124-1 also require other-than-temporary impaired debt securities to be written down to its impaired value, which becomes the new cost basis. FSP Nos. FAS 115-1 and FAS 124-1 are effective for fiscal periods beginning after December 15, 2005 and are required to be adopted by the Company in the second quarter of fiscal 2006. Although the Company will continue to evaluate the application of FSP Nos. FAS 115-1 and FAS 124-1, management does not currently believe adoption will have a material impact on the Company's results of operations or financial position.

In December 2004, the FASB issued FSP 109-2, *Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision within the American Jobs Creation Act of 2004*. FSP 109-2 provides additional time to companies beyond the financial reporting period of enactment to evaluate the effects of the AJCA on their plans for repatriation of foreign earnings for purposes of applying SFAS 109, *Accounting for Income Taxes*. The Company is continuing to evaluate the repatriation provisions of AJCA, which if implemented by the Company would affect the Company's tax provision and deferred tax assets and liabilities. However, given the uncertainties and complexities of the repatriation provision and the Company's continuing evaluation, the Company has not yet determined the amount, if any, that will be repatriated or the related potential income tax effects of such repatriation. The Company expects to complete the evaluation in fiscal 2006.

In May 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections* which replaces APB Opinion No. 20 *Accounting Changes* and SFAS No. 3, *Reporting Accounting Changes in Interim Financial Statements—An Amendment of APB Opinion No. 28*. SFAS No. 154 requires retrospective application to prior periods' financial statements of a voluntary change in accounting principal unless it is not practicable. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005 and is required to be adopted by the Company in the first quarter of fiscal 2007. Although the Company will continue to evaluate the application of SFAS No. 154, management does not currently believe adoption will have a material impact on the Company's results of operations or financial position.

Liquidity and Capital Resources

The following table presents selected financial information and statistics for each of the fiscal quarters ended on the dates indicated (dollars in millions):

	12/31/05	9/24/05
Cash, cash equivalents, and short-term investments	$ 8,707	$ 8,261
Accounts receivable, net	$ 1,331	$ 895
Inventory	$ 244	$ 165
Working capital	$ 7,102	$ 6,816
Days sales in accounts receivable (DSO) (a)	23	22
Days of supply in inventory (b)	6	6
Days payables outstanding (DPO) (c)	67	62
Operating cash flow (quarterly)	$ 283	$ 752

(a) DSO is based on ending net trade receivables and most recent quarterly net sales for each period.
(b) Days supply of inventory is based on ending inventory and most recent quarterly cost of sales for each period.
(c) DPO is based on ending accounts payable and most recent quarterly cost of sales adjusted for the change in inventory.

As of December 31, 2005, the Company had $8.7 billion in cash, cash equivalents, and short-term investments, an increase of $446 million over the same balances at the end of 2005. The principal components of this net increase were cash generated by operating activities of $283 million that includes a $750 million prepayment made to certain vendors for the future supply of NAND flash memory components, proceeds from the issuance of common stock under stock plans of $134 million, and tax benefits from stock option exercises of $149 million. The Company's short-term investment portfolio is primarily invested in high credit quality, liquid investments. Approximately $4.8 billion of this cash, cash equivalents, and short-term investments is held by the Company's foreign subsidiaries and

Source: APPLE COMPUTER INC, 10-Q, February 03, 2006

would be subject to U.S. income taxation on repatriation to the U.S. The Company is currently assessing the impact of the one–time favorable foreign dividend provisions recently enacted as part of the AJCA, and may decide to repatriate earnings from some of its foreign subsidiaries.

In the second quarter of 2006, the Company made an additional prepayment of $500 million for the future supply of NAND flash memory components.

In addition, during the second quarter of 2006, 10 million shares of restricted stock and 2.4 million restricted stock units (RSUs) previously granted to certain Company executives are scheduled to vest. The majority of these are expected to be net–share settled, thus the Company will withhold from the executives sufficient shares to satisfy the executives' obligation for their applicable income and other employment taxes, and will remit an equivalent amount of cash to the appropriate taxing authorities. The number of shares withheld will be based on the value of the restricted stock and RSUs on their respective vesting dates. The remaining shares net of those withheld will be delivered to the Company executives. The amounts of these tax withholdings and remittances in cash to the taxing authorities will be a function of the Company's stock price on the respective vesting dates, but using the closing price of the Company's stock on January 27, 2006 of $72.03 as a proxy, the total payments for the employees' tax obligations to the taxing authorities would be approximately $398 million. These transactions will not represent expenses to the Company but will be accounted for as reductions to cash with corresponding reductions to shareholders' equity. These net–share settlements will have the effect of share repurchases by the Company as they will reduce and retire the number of shares that would have otherwise been issued as a result of the vesting.

The Company believes its existing balances of cash, cash equivalents, and short–term investments will be sufficient to satisfy its working capital needs, capital expenditures, stock repurchase activity, outstanding commitments, and other liquidity requirements associated with its existing operations over the next 12 months.

Capital Expenditures
The Company's total capital expenditures were $82 million during the first quarter of fiscal 2006, $40 million of which were for retail store facilities and equipment related to the Company's Retail segment and $42 million of which were for corporate infrastructure, including information systems enhancements and operating facilities enhancements and expansions. The Company currently anticipates it will utilize approximately $420 million for capital expenditures during 2006, approximately $210 million of which is expected to be utilized for expansion of the Company's Retail segment and the remainder utilized to support normal replacement of existing capital assets and enhancements to general information technology infrastructure.

Stock Repurchase Plan
In July 1999, the Company's Board of Directors authorized a plan for the Company to repurchase up to $500 million of its common stock. This repurchase plan does not obligate the Company to acquire any specific number of shares or acquire shares over any specified period of time. Since inception of the stock repurchase plan, the Company has repurchased a total of 13.1 million shares at a cost of $217 million. The Company did not repurchase any shares during the first quarter of 2006. The Company was authorized to repurchase up to an additional $283 million of its common stock as of December 31, 2005.

Off–Balance Sheet Arrangements and Contractual Obligations
The Company has not entered into any transactions with unconsolidated entities whereby the Company has financial guarantees, subordinated retained interests, derivative instruments or other contingent arrangements that expose the Company to material continuing risks, contingent liabilities, or any other obligation under a variable interest in an unconsolidated entity that provides financing, liquidity, market risk or credit risk support to the Company.

Lease Commitments
As of September 24, 2005, the Company had total outstanding commitments on noncancelable operating leases of approximately $865 million, $606 million of which related to the lease of retail space and related facilities. The major facility leases are for terms of five to 15 years and generally provide renewal options for terms of three to five additional years. Leases for retail space are for terms of five to 20 years, the majority of which are for 10 years, and often contain multi–year renewal options. Total outstanding commitments on noncancelable operating leases related to the lease of retail space rose to $705 million as of December 31, 2005.

Source: APPLE COMPUTER INC, 10-Q, February 03, 2006

Purchase Commitments with Contract Manufacturers and Component Suppliers
The Company utilizes several contract manufacturers to manufacture sub-assemblies for the Company's products and to perform final assembly and test of finished products. These contract manufacturers acquire components and build product based on demand information supplied by the Company, which typically covers periods ranging from 30 to 150 days. The Company also obtains individual components for its products from a wide variety of individual suppliers. Consistent with industry practice, the Company acquires components through a combination of purchase orders, supplier contracts, and open orders based on projected demand information. Such purchase commitments typically cover the Company's forecasted component and manufacturing requirements for periods ranging from 30 to 150 days. As of December 31, 2005, the Company had outstanding third-party manufacturing commitments and component purchase commitments of approximately $2.0 billion.

During the first quarter of 2006, the Company entered into long-term supply agreements with Hynix Semiconductor, Inc., Intel Corporation, Micron Technology, Inc., Samsung Electronics Co., Ltd., and Toshiba Corporation to secure supply of NAND flash memory through calendar year 2010. As part of these agreements, the Company agreed to prepay $1.25 billion for flash memory components of which $750 million was paid during the first quarter of 2006 and the remaining $500 million was paid in the second quarter of 2006. These prepayments will be applied to inventory purchases made over the life of each respective agreement.

Asset Retirement Obligations
The Company's asset retirement obligations are associated with commitments to return property subject to operating leases to original condition upon lease termination. As of December 31, 2005, the Company estimated that gross expected future cash flows of approximately $17 million would be required to fulfill these obligations.

Other Obligations
Other obligations increased to approximately $52 million as of December 31, 2005 primarily related to telecommunications services contracts that were renewed in the first quarter of 2006 for a 2 year period.

Indemnifications
The Company generally does not indemnify end-users of its operating system and application software against legal claims that the software infringes third-party intellectual property rights. Other agreements entered into by the Company sometimes include indemnification provisions under which the Company could be subject to costs and/or damages in the event of an infringement claim against the Company or an indemnified third-party. However, the Company has not been required to make any significant payments resulting from such an infringement claim asserted against itself or an indemnified third-party and, in the opinion of management, does not have a liability related to unresolved infringement claims subject to indemnification that would have a material adverse effect on its financial condition, liquidity or results of operations.

Factors That May Affect Future Results and Financial Condition
Because of the following factors, as well as other factors affecting the Company's operating results and financial condition, past financial performance should not be considered to be a reliable indicator of future performance, and investors should not use historical trends to anticipate results or trends in future periods.

General economic conditions and current economic and political uncertainty could adversely affect the demand for the Company's products and the financial health of its suppliers, distributors, and resellers.
The Company's operating performance depends significantly on general economic conditions in the U.S. and abroad. At times in the past, demand for the Company's products has been negatively impacted by difficult global economic conditions. Additionally, some of the Company's education customers appeared to be delaying technology purchases due to concerns about the overall impact of the weaker economy and state budget deficits on their available funding. Although recent macroeconomic trends seem to indicate an economic recovery, continued uncertainty about future economic conditions makes it difficult to forecast future demand for the Company's products and related operating results. Should global and/or regional economic conditions deteriorate, demand for the Company's products could be adversely affected, as could the financial health of its suppliers, distributors, and resellers.

War, terrorism, public health issues or other business interruptions could disrupt supply, delivery or demand of products, which could negatively affect the Company's operations and performance.
War, terrorism, public health issues and other business interruptions whether in the U.S. or abroad, have caused and could cause damage or disruption to international commerce by creating economic and political uncertainties that may have a strong negative impact on the global economy, the Company, and the Company's suppliers or customers.

Source: APPLE COMPUTER INC, 10-Q, February 03, 2006

The Company's major business operations are subject to interruption by earthquake, other natural disasters, fire, power shortages, terrorist attacks and other hostile acts, labor disputes, public health issues, and other events beyond its control. The majority of the Company's research and development activities, its corporate headquarters, information technology systems, and other critical business operations, including certain component suppliers and manufacturing vendors, are located near major seismic faults. Because the Company does not carry earthquake insurance for direct quake-related losses, the Company's operating results and financial condition could be materially adversely affected in the event of a major earthquake or other natural or manmade disaster.

Although it is impossible to predict the occurrences or consequences of any such events, such events could result in a decrease in demand for the Company's products, make it difficult or impossible for the Company to deliver products to its customers or to receive components from its suppliers, and could create delays and inefficiencies in the Company's supply chain. In addition, should major public health issues, including pandemics, arise, the Company could be negatively impacted by the need for more stringent employee travel restrictions, additional limitations in the availability of freight services, governmental actions limiting the movement of products between various regions, delays in production ramps of new products, and disruptions in the operations of the Company's manufacturing vendors and component suppliers. The Company's operating results and financial condition have been, and in the future may be, adversely affected by these events.

The market for personal computers and related peripherals and services, as well as digital music devices and related services, is highly competitive. If the Company is unable to effectively compete in these markets, its results of operations could be adversely affected.

The personal computer industry is highly competitive and is characterized by aggressive pricing practices, downward pressure on gross margins, frequent introduction of new products, short product life cycles, evolving industry standards, continual improvement in product price/performance characteristics, rapid adoption of technological and product advancements by competitors, price sensitivity on the part of consumers, and a large number of competitors. Over the past several years, price competition in the market for personal computers and related peripherals has been particularly intense as competitors who sell Windows and Linux based personal computers have aggressively cut prices and lowered their product margins for personal computing products. The Company's results of operations and financial condition have been, and in the future may continue to be, adversely affected by these and other industry-wide pricing pressures and downward pressures on gross margins.

The personal computer industry has also been characterized by rapid technological advances in software functionality, hardware performance, and features based on existing or emerging industry standards. Further, as the personal computer industry and its customers place more reliance on the Internet, an increasing number of Internet devices that are smaller and simpler than traditional personal computers may compete for market share with the Company's existing products. Several competitors of the Company have either targeted or announced their intention to target certain of the Company's key market segments, including consumer, education, professional and consumer digital video editing, and design and publishing. Several of the Company's competitors have introduced or announced plans to introduce digital music products and/or online stores offering digital music distribution that mimic many of the unique design, technical features, and solutions of the Company's products. The Company has a significant number of competitors, many of whom have greater financial, marketing, manufacturing, and technological resources, as well as broader product lines and larger installed customer bases than those of the Company. Additionally, there has been a trend towards consolidation in the personal computer industry that has resulted in larger and potentially stronger competitors in the Company's markets.

The Company is currently the only maker of hardware using the Mac OS. The Mac OS has a minority market share in the personal computer market, which is dominated by makers of computers utilizing other competing operating systems, including Windows and Linux. The Company's future operating results and financial condition are substantially dependent on its ability to continue to develop improvements to the Macintosh platform in order to maintain perceived design and functional advantages over competing platforms. Additionally, if unauthorized copies of the Mac OS are used on other companies' hardware products and result in decreased demand for the Company's hardware products, the Company's results of operations may be adversely affected.

The Company is currently focused on market opportunities related to digital music distribution and related consumer electronic devices, including iPods. The Company faces increasing competition from other companies promoting their own digital music products, including music enabled cell phones, distribution services, and free peer-to-peer music services. These competitors include both new entrants with different market approaches, such as subscription

Source: APPLE COMPUTER INC, 10-Q, February 03, 2006

services models, and also larger companies that may have greater technical, marketing, distribution, and other resources than those of the Company, as well as established hardware, software, and digital content supplier relationships. Failure to effectively compete could negatively affect the Company's operating results and financial position. There can be no assurance that the Company will be able to continue to provide products and services that effectively compete in these markets or successfully distribute and sell digital music outside the U.S. The Company may also have to respond to price competition by lowering prices and/or increasing features which could adversely affect the Company's music product gross margins as well as overall Company gross margins.

The Company also faces increased competition in the U.S. education market. U.S. elementary and secondary schools, as well as college and university customers, remain a core market for the Company. Uncertainty in this channel remains as several competitors of the Company have either targeted or announced their intention to target the education market for personal computers, which could negatively affect the Company's market share. In an effort to regain market share and remain competitive, the Company has been and will continue to pursue one-to-one (1:1) learning solutions in education. 1:1 learning solutions typically consist of iBook portable systems for every student and teacher along with a wireless network connected to a central server. These 1:1 learning solutions and other strategic sales are generally priced more aggressively and could result in significantly less profitability or even in financial losses, particularly for larger deals. Although the Company believes it has taken certain steps to strengthen its position in the education market, there can be no assurance that the Company will be able to increase or maintain its share of the education market or execute profitably on large strategic arrangements. Failure to do so may have an adverse impact on the Company's operating results and financial condition.

The Company's transition from PowerPC microprocessors used by Macintosh computers to microprocessors built by Intel is subject to numerous risks.

In June 2005, the Company announced its intention to transition from the use of PowerPC microprocessors to the use of Intel microprocessors in all of its Macintosh computers by the end of calendar year 2007. In January 2006, the Company announced the new iMac® and MacBook™ Pro, which are the first Macintosh computers to run on Intel microprocessors. The Company now expects to complete this transition by the end of calendar year 2006. This transition is subject to numerous risks and uncertainties, including the Company's ability to timely develop and deliver new products using Intel microprocessors, the timely innovation and delivery of related hardware and software products, including the Company's applications, to support Intel microprocessors, market acceptance of Intel-based Macintosh computers, the development and availability on acceptable terms of components and services essential to enable the Company to timely deliver Intel-based Macintosh computers, and the effective management of inventory levels in line with anticipated product demand for both PowerPC and Intel-based Macintosh computers. In addition, the Company is dependent on third-party software developers such as Microsoft and Adobe continuing to support current applications that run on PowerPC-based computers and timely developing versions of current and future applications that run on Intel and PowerPC-based Macintosh computers. The Company's inability to timely deliver new Intel-based products or obtain developer commitment both to continue supporting applications that run on PowerPC microprocessors and timely transition their applications to run natively on Intel-based products may have an adverse impact on the Company's results of operations. The Company's announcement of its intention to transition to Intel microprocessors may negatively impact sales of current and future Macintosh products containing PowerPC microprocessors, as customers may elect to delay purchases until the Intel-based products are available. Additionally, there can be no assurance that the Company will be able to maintain its historical gross margin percentages on its products, including Intel-based Macintosh computers, which may adversely impact the Company's results of operations.

Future operating results are dependent upon the Company's ability to obtain a sufficient supply of components, including microprocessors, some of which are in short supply or available only from limited sources.

Although most components essential to the Company's business are generally available from multiple sources, certain key components including microprocessors and ASICs are currently obtained by the Company from single or limited sources. Some key components (including without limitation DRAM, NAND flash-memory, and TFT-LCD flat-panel displays), while currently available to the Company from multiple sources, are at times subject to industry-wide availability and pricing pressures. In addition, new products introduced by the Company often initially utilize custom components obtained from only one source until the Company has evaluated whether there is a need for, and subsequently qualifies additional suppliers. In situations where a component or product utilizes new technologies, initial capacity constraints may exist until such time as the suppliers' yields have matured. The Company and other producers in the personal computer industry also compete for various components with other industries that have experienced increased demand for their products. The Company uses some components that are not common to the

Source: APPLE COMPUTER INC, 10-Q, February 03, 2006

rest of the personal computer industry including certain microprocessors and ASICs. Continued availability of these components may be affected if producers were to decide to concentrate on the production of components other than those customized to meet the Company's requirements. If the supply of a key component were to be delayed or constrained on a new or existing product, the Company's results of operations and financial condition could be adversely affected.

The Company's ability to produce and market competitive products is dependent on the ability and desire of IBM and Freescale Semiconductor, Inc. (Freescale) to supply PowerPC microprocessors and Intel to supply its microprocessors for the Company's Macintosh computers and to provide the Company with a sufficient supply of microprocessors with price/performance features that compare favorably to those supplied to the Company's competitors. While the Company has supply agreements with IBM and Freescale, the Company's recent announcement of plans to transition to Intel microprocessors may impact the continued availability on acceptable terms of certain components and services, including PowerPC G4 and G5 microprocessors, which are essential to the Company's business and are currently obtained by the Company from sole or limited sources. Additionally, there have been instances in recent years where the inability of the Company's suppliers to provide advanced PowerPC microprocessors in sufficient quantity has had significant adverse effects on the Company's results of operations. In addition, IBM is currently the Company's sole supplier of the PowerPC G5 processor, which is used in the Company's current Power Mac and Xserve products. Freescale is the sole supplier of the G4 processor, which is used in the Company's eMac, Mac mini, and certain portable products. Manufacturing problems experienced by any of the Company's suppliers in the future or failure by them to deliver components to the Company in sufficient quantities with competitive price/performance features could adversely affect the Company's results of operations and financial condition.

The Company must successfully manage frequent product introductions and transitions to remain competitive and effectively stimulate customer demand.
Due to the highly volatile and competitive nature of the personal computer and consumer electronics industries, which are characterized by dynamic customer demand patterns and rapid technological advances, the Company must continually introduce new products and technologies, enhance existing products in order to remain competitive, and effectively stimulate customer demand for new products and upgraded versions of the Company's existing products. The success of new product introductions is dependent on a number of factors, including market acceptance; the Company's ability to manage the risks associated with product transitions, including the transition to Intel-based Macintosh computers, and production ramp issues; the availability of application software for new products; the effective management of purchase commitments and inventory levels in line with anticipated product demand, including anticipated demand for PowerPC-based and Intel-based Macintosh computers; the availability of products in appropriate quantities to meet anticipated demand; and the risk that new products may have quality or other defects in the early stages of introduction. Accordingly, the Company cannot determine in advance the ultimate effect that new products will have on its sales or results of operations.

The Company's products from time to time experience quality problems that can result in decreased net sales and operating profits.
The Company sells highly complex hardware and software products that can contain defects in design and manufacture. Sophisticated operating system software and applications, such as those sold by the Company, often contain "bugs" that can unexpectedly interfere with the operation of the software. Defects may also occur in components and products the Company purchases from third-parties. There can be no assurance that the Company will be able to detect and fix all defects in the hardware and software it sells. Failure to do so could result in lost revenue, loss of reputation, and significant warranty and other expense to remedy.

Because orders for components, and in some cases commitments to purchase components, must be placed in advance of customer orders, the Company faces substantial inventory risk.
The Company records a write-down for inventories of components and products that have become obsolete or are in excess of anticipated demand or net realizable value and accrues necessary reserves for cancellation fees of orders for inventories that have been cancelled. Although the Company believes its inventory and related provisions are currently adequate, given the rapid and unpredictable pace of product obsolescence in the computer and consumer electronics industries and the transition to Intel-based Macintosh computers, no assurance can be given that the Company will not incur additional inventory and related charges. In addition, such charges have had, and may have, a material effect on the Company's financial position and results of operations.

Source: APPLE COMPUTER INC, 10-Q, February 03, 2006

The Company must order components for its products and build inventory in advance of product shipments. Because the Company's markets are volatile and subject to rapid technology and price changes, and because of the transition to Intel-based Macintosh computers, there is a risk the Company will forecast incorrectly and produce or order from third parties excess or insufficient inventories of particular products. Consistent with industry practice, components are normally acquired through a combination of purchase orders, supplier contracts, and open orders based on projected demand information. Such purchase commitments typically cover the Company's forecasted component and manufacturing requirements for periods ranging from 30 to 150 days. The Company's operating results and financial condition have been in the past and may in the future be materially adversely affected by the Company's ability to manage its inventory levels and respond to short-term shifts in customer demand patterns.

The Company is dependent on manufacturing and logistics services provided by third parties, many of whom are located outside of the U.S.
Most of the Company's products are manufactured in whole or in part by third-party manufacturers. In addition, the Company has outsourced much of its transportation and logistics management. While outsourcing arrangements may lower the cost of operations, they also reduce the Company's direct control over production and distribution. It is uncertain what effect such diminished control will have on the quality or quantity of the products manufactured or services rendered, or the flexibility of the Company to respond to changing market conditions. Moreover, although arrangements with such manufacturers may contain provisions for warranty expense reimbursement, the Company may remain at least initially responsible to the consumer for warranty service in the event of product defects. Any unanticipated product defect or warranty liability, whether pursuant to arrangements with contract manufacturers or otherwise, could adversely affect the Company's future operating results and financial condition.

Final assembly of products sold by the Company is currently performed in the Company's manufacturing facility in Cork, Ireland, and by external vendors in Fremont, California, Fullerton, California, Taiwan, Korea, the People's Republic of China, and the Czech Republic. Currently, manufacturing of many of the components used in the Company's products is performed by third-party vendors in Taiwan, China, Japan, Korea, and Singapore. Final assembly of substantially all of the Company's portable products including PowerBooks, iBooks, and iPods is performed by third-party vendors in China. If for any reason manufacturing or logistics in any of these locations is disrupted by regional economic, business, labor, environmental, public health, or political issues, or due to information technology system failures or military actions, the Company's results of operations and financial condition could be adversely affected.

The Company's future operating performance is dependent on the performance of distributors and other resellers of the Company's products.
The Company distributes its products through wholesalers, resellers, national and regional retailers, and cataloguers, many of whom distribute products from competing manufacturers. In addition, the Company sells many of its products and resells certain third-party products in most of its major markets directly to end users, certain education customers, and certain resellers through its online stores around the world and its retail stores. Many of the Company's resellers operate on narrow product margins and have been negatively affected by weak economic conditions over the last several years. Considerable trade receivables that are not covered by collateral or credit insurance are outstanding with the Company's distribution and retail channel partners. The Company's business and financial results could be adversely affected if the financial condition of these resellers weakens, if resellers within consumer channels were to cease distribution of the Company's products, or if uncertainty regarding demand for the Company's products caused resellers to reduce their ordering and marketing of the Company's products. The Company has invested and will continue to invest in various programs to enhance reseller sales, including staffing selected resellers' stores with Company employees and contractors. These programs could require a substantial investment from the Company, while providing no assurance of return or incremental revenue to offset this investment.

Over the past several years, an increasing proportion of the Company's net sales has been made by the Company directly to end-users through its online stores around the world and through its retail stores in the U.S., Canada, Japan, and the U.K. Some of the Company's resellers have perceived this expansion of the Company's direct sales as conflicting with their own businesses and economic interests as distributors and resellers of the Company's products. Perception of such a conflict could discourage the Company's resellers from investing additional resources in the distribution and sale of the Company's products or lead them to limit or cease distribution of the Company's products. The Company's business and financial results could be adversely affected if expansion of its direct sales to end-users causes some or all of its resellers to cease or limit distribution of the Company's products.

Source: APPLE COMPUTER INC, 10-Q, February 03, 2006

Further information regarding risks associated with Marketing and Distribution may be found in Part I, Item 1 of the 2005 Form 10-K for the year ended September 24, 2005 under the heading "Markets and Distribution."

The Company relies on third-party digital content, which may not be available to the Company on commercially reasonable terms or at all.
The Company contracts with third parties to offer their digital content to customers through the Company's iTunes Music Store. The Company pays substantial fees to obtain the rights to offer to its customers this third-party digital content. The Company's licensing arrangements with these third-party content providers are short-term in nature and do not guarantee the future renewal of these arrangements at commercially reasonable terms, if at all. Certain parties in the music industry have consolidated and formed alliances, which could limit the availability and increase the fees required to offer digital content to customers through the iTunes Music Store. Further, some third-party content providers currently, or may in the future, offer music products and services that compete with the Company's music products and services, and could take action to make it more difficult or impossible for the Company to license their digital content in the future. If the Company is unable to continue to offer a wide variety of digital content at reasonable prices with acceptable usage rules, or continue to expand its geographic reach outside the U.S., then sales and gross margins of the Company's iTunes Music Store as well as related hardware and peripherals, including iPods, may be adversely affected.

Third-party content providers and artists require that the Company provide certain digital rights management solutions and other security mechanisms. If the requirements from content providers or artists change, then the Company may be required to further develop or license technology to address such new rights and requirements. There is no assurance that the Company will be able to develop or license such solutions at a reasonable cost and in a timely manner, if at all, which could have a materially adverse effect on the Company's operating results and financial position.

The Company's future performance is dependent upon support from third-party software developers. If third-party software applications cease to be developed or available for the Company's hardware products, then customers may choose not to buy the Company's products.
The Company believes that decisions by customers to purchase the Company's personal computers, as opposed to Windows-based systems, are often based on the availability of third-party software for particular applications such as Microsoft Office. The Company also believes the availability of third-party application software for the Company's hardware products depends in part on third-party developers' perception and analysis of the relative benefits of developing, maintaining, and upgrading such software for the Company's products versus software for the larger Windows market or growing Linux market. This analysis may be based on factors such as the perceived strength of the Company and its products, the anticipated potential revenue that may be generated, continued acceptance by customers of Mac OS X, and the costs of developing such software products. To the extent the minority market share held by the Company in the personal computer market has caused software developers to question the Company's prospects in the personal computer market, developers could be less inclined to develop new application software or upgrade existing software for the Company's products and more inclined to devote their resources to developing and upgrading software for the larger Windows market or growing Linux market. Moreover, there can be no assurance software developers will continue to develop software for Mac OS X, the Company's operating system, on a timely basis or at all.

In June 2005, the Company announced its plan to begin using Intel microprocessors in its Macintosh computers and in January 2006 announced the new iMac® and MacBook™ Pro, which are the first Macintosh computers to run on Intel microprocessors. The Company expects to complete this transition to Intel microprocessors for all of its Macintosh computers by the end of calendar year 2006. The Company depends on third-party software developers to timely develop current and future applications that run on Intel and PowerPC microprocessors. The Company's inability to timely deliver new Intel-based products, or a decline in available applications that run on the Company's PowerPC products or the lack of applications that run on Intel-based Macintosh systems could have a materially adverse effect on the Company's operating results and financial position.

In addition, past and future development by the Company of its own software applications and solutions may negatively impact the decision of software developers, such as Microsoft and Adobe, to develop, maintain, and upgrade similar or competitive software for the Company's products. The Company currently markets and sells a variety of software applications for use by professionals, consumers, and education customers that could influence

Source: APPLE COMPUTER INC, 10-Q, February 03, 2006

the decisions of third-party software developers to develop or upgrade Macintosh-compatible software products. Software applications currently marketed by the Company include software for professional film and video editing, professional compositing and visual effects for large format film and video productions, professional music production and music post production, professional and consumer DVD encoding and authoring, professional digital photo editing and workflow management, consumer digital video and digital photo editing and management, digital music management, desktop-based database management, word processing, and high-quality presentations. The Company also markets an integrated productivity application that incorporates word processing, page layout, image manipulation, spreadsheets, databases, and presentations in a single application. Discontinuance of third-party products for the Macintosh platform could have an adverse effect on the Company's net sales and results of operations.

The Company's business relies on access to patents and intellectual property obtained from third parties, and the Company's future results could be adversely affected if it is alleged or found to have infringed on the intellectual property rights of others.
Many of the Company's products are designed to include intellectual property obtained from third parties. While it may be necessary in the future to seek or renew licenses relating to various aspects of its products and business methods, the Company believes that based upon past experience and industry practice, such licenses generally could be obtained on commercially reasonable terms. However, there can be no assurance that the necessary licenses would be available or available on acceptable terms.

Because of technological changes in the computer and consumer electronics industries, current extensive patent coverage, and the rapid rate of issuance of new patents, it is possible certain components of the Company's products and business methods may unknowingly infringe existing patents of others. The Company has from time to time been notified that it may be infringing certain patents or other intellectual property rights of others. Responding to such claims, regardless of their merit, can be time-consuming, result in significant expenses, and cause the diversion of management and technical personnel. Several pending claims are in various stages of evaluation. The Company may consider the desirability of entering into licensing agreements in certain of these cases. However, no assurance can be given that such licenses can be obtained on acceptable terms or that litigation will not occur. In the event there is a temporary or permanent injunction entered prohibiting the Company from marketing or selling certain of its products or a successful claim of infringement against the Company requiring it to pay royalties to a third-party, the Company's future operating results and financial condition could be adversely affected. Information regarding certain claims and litigation involving the Company related to alleged patent infringement and other matters is set forth in Part II, Item 1 of this Form 10-Q and Part I, Item 3 of the 2005 Form 10-K. In the opinion of management, the Company does not have a potential liability for damages or royalties from any current legal proceedings or claims related to the infringement of patent or other intellectual property rights of others that would individually or in the aggregate have a material adverse effect on its results of operations, or financial condition. However, the results of such legal proceedings cannot be predicted with certainty. Should the Company fail to prevail in any of the matters related to infringement of patent or other intellectual property rights of others described in Part II, Item 1 of this Form 10-Q and Part I, Item 3 of the 2005 Form 10-K or should several of these matters be resolved against the Company in the same reporting period, the operating results of a particular reporting period could be materially adversely affected.

The Company's retail initiative has required and will continue to require a substantial investment and commitment of resources and is subject to numerous risks and uncertainties.
Through January 31, 2006, the Company had opened 136 retail stores. The Company's retail initiative has required substantial investment in equipment and leasehold improvements, information systems, inventory, and personnel. The Company has also entered into substantial operating lease commitments for retail space with lease terms ranging from five to 20 years, the majority of which are for 10 years. The Company could incur substantial costs should it choose to terminate this initiative or close individual stores. Such costs could adversely affect the Company's results of operations and financial condition. Additionally, a relatively high proportion of the Retail segment's costs are fixed because of depreciation on store construction costs and lease expense. As a result, significant losses would result should the Retail segment experience a significant decline in sales for any reason.

Certain of the Company's stores have been designed and built to serve as high profile venues that function as vehicles for general corporate marketing, corporate events, and brand awareness. Because of their unique design elements, locations and size, these stores require substantially more investment in equipment and leasehold improvements than the Company's more typical retail stores. The Company has opened seven such stores through January 2006. Because of their location and size, these high profile stores also require the Company to enter into

Source: APPLE COMPUTER INC, 10-Q, February 03, 2006

substantially larger operating lease commitments compared to those required for its more typical stores. Current leases on such locations have terms ranging from 10 to 14 years with total remaining commitments per location ranging from $4 million to $47 million. Closure or poor performance of one of these high profile stores could have a particularly significant negative impact on the Company's results of operations and financial condition.

Many of the general risks and uncertainties the Company faces could also have an adverse impact on its Retail segment. Also, many factors unique to retail operations present risks and uncertainties, some of which are beyond the Company's control, that could adversely affect the Retail segment's future results, cause its actual results to differ from those currently expected, and/or have an adverse effect on the Company's consolidated results of operations. Potential risks and uncertainties unique to retail operations that could have an adverse impact on the Retail segment include, among other things, macro-economic factors that have a negative impact on general retail activity; inability to manage costs associated with store construction and operation; failure to attract new users to the Macintosh platform; inability to sell third-party hardware and software products at adequate margins; failure to manage relationships with existing retail channel partners; lack of experience in managing retail operations outside the U.S.; costs associated with unanticipated fluctuations in the value of Apple-branded and third-party retail inventory; and inability to obtain quality retail locations at reasonable cost.

Investment in new business strategies and initiatives could disrupt the Company's ongoing business and may present risks not originally contemplated.
The Company has and may in the future invest in new business strategies or engage in acquisitions that complement the Company's strategic direction and product roadmap. Such endeavors may involve significant risks and uncertainties, including distraction of management's attention away from normal business operations; insufficient revenue generation to offset liabilities assumed and expenses associated with the strategy; and unidentified issues not discovered in the Company's due diligence process. Because these new ventures are inherently risky, no assurance can be given that such strategies and initiatives will be successful and will not materially adversely affect the Company's business, operating results or financial condition.

Declines in the sales of the Company's professional products, software, accessories, or service and support contracts, or increases in sales of consumer products, including iPods, may negatively impact the Company's gross margin and operating margin percentages.
The Company's professional products, including Power Macintosh and PowerBook systems, software, accessories, and service and support contracts, generally have higher gross margins than the Company's consumer products, including iMacs, iBooks, iPods, and content from the iTunes Music Store. A shift in sales mix away from higher margin professional products towards lower margin consumer products could adversely affect the Company's future gross margin and operating margin percentages. The Company's traditional professional customers may choose to buy consumer products, specifically the iMac and iBook, instead of professional products. Professional users may choose to buy the iMac due to its relative price performance, use of a more powerful Intel microprocessor, and unique design featuring a flat panel screen. Professional users may also choose to purchase iBooks instead of the Company's professional-oriented portable products due to their price performance and screen size. Additionally, significant future growth in iPod sales without corresponding growth in higher margin product sales could also reduce gross margin and operating margin percentages.

The Company expects its quarterly revenue and operating results to fluctuate for a variety of reasons.
The Company's profit margins vary among its products and its distribution channels. The Company's direct sales, primarily through its retail and online stores, generally have higher associated profitability than its indirect sales. Additionally, the Company's direct channels have traditionally had more sales of software and higher priced hardware products, which generally have higher gross margins, than its indirect channels. As a result, the Company's gross margin and operating margin percentages as well as overall profitability may be adversely impacted as a result of a shift in product, geographic, or channel mix, or new product announcements, including the transition to Intel-based Macintosh computers. In addition, the Company generally sells more products during the third month of each quarter than it does during either of the first two months, a pattern typical in the personal computer industry. This sales pattern can produce pressure on the Company's internal infrastructure during the third month of a quarter and may adversely impact the Company's ability to predict its financial results accurately. Furthermore, the Company has typically experienced greater net sales in the first and fourth fiscal quarters compared to other quarters in the fiscal year due to seasonal demand related to the holiday season and the beginning of the school year. Developments late in a quarter, such as lower-than-anticipated demand for the Company's products, an

Source: APPLE COMPUTER INC, 10-Q, February 03, 2006

internal systems failure, or failure of one of the Company's key logistics, components suppliers, or manufacturing partners, can have significant adverse impacts on the Company and its results of operations and financial condition.

The Company has higher research and development and selling, general and administrative costs, as a percentage of revenue, than many of its competitors.
The Company's ability to compete successfully and maintain attractive gross margins and revenue growth is heavily dependent upon its ability to ensure a continuing and timely flow of innovative and competitive products and technologies to the marketplace. As a result, the Company generally incurs higher research and development costs as a percentage of revenue than its competitors who sell personal computers based on other operating systems. Many of these competitors seek to compete aggressively on price and maintain very low cost structures. Further, as a result of the expansion of the Company's Retail segment and costs associated with marketing the Company's brand including its unique operating system, the Company incurs higher selling costs as a percentage of revenue than many of its competitors. If the Company is unable to continue to develop and sell innovative new products with attractive gross margins, its results of operations may be materially adversely affected by its operating cost structure.

The Company is exposed to credit risk on its accounts receivable and prepayments related to long-term supply agreements. This risk is heightened during periods when economic conditions worsen.
The Company distributes its products through third-party computer resellers and retailers and directly to certain educational institutions and commercial customers. A substantial majority of the Company's outstanding trade receivables are not covered by collateral or credit insurance. The Company also has unsecured non-trade receivables from certain of its manufacturing vendors resulting from the sale by the Company of raw material components to these manufacturing vendors who manufacture sub-assemblies or assemble final products for the Company. In addition, the Company has entered into long-term supply agreements to secure supply of NAND flash-memory and has prepaid a total of $1.25 billion under these agreements. While the Company has procedures in place to monitor and limit exposure to credit risk on its trade and non-trade receivables as well as long-term prepayments, there can be no assurance that such procedures will be effective in limiting its credit risk and avoiding losses. Additionally, if the global economy and regional economies fail to improve or continue to deteriorate, it becomes more likely that the Company will incur a material loss or losses as a result of the weakening financial condition of one or more of its customers or manufacturing vendors.

The Company's success depends largely on its ability to attract and retain key personnel.
Much of the future success of the Company depends on the continued service and availability of skilled personnel, including its Chief Executive Officer, members of its executive team, and those in technical, marketing and staff positions. Experienced personnel in the information technology industry are in high demand and competition for their talents is intense, especially in the Silicon Valley, where the majority of the Company's key employees are located. The Company has relied on its ability to grant stock options as one mechanism for recruiting and retaining this highly skilled talent. Recent accounting regulations requiring the expensing of stock options have resulted in increased stock-based compensation expense, which may cause the Company to reduce the amount of stock-based awards issued to employees. There can be no assurance that the Company will continue to successfully attract and retain key personnel.

The Company is subject to risks associated with the selection, availability, and cost of insurance.
The Company has observed rapidly changing conditions in the insurance markets relating to nearly all areas of traditional commercial insurance. Such conditions have and may continue to result in higher premium costs, higher policy deductibles, lower coverage limits and may also yield possible policy form exclusions. For some risks, because of cost and/or availability, the Company does not have insurance coverage. Because the Company retains some portion of its insurable risks, and in some cases self insures completely, unforeseen or catastrophic losses in excess of insured limits may have a material adverse effect on the Company's results of operations and financial position.

Failure of information technology systems and breaches in the security of data upon which the Company relies could adversely affect the Company's future operating results.
Information technology system failures and breaches of data security could disrupt the Company's ability to function in the normal course of business by potentially causing delays or cancellation of customer orders, impeding the manufacture or shipment of products, or resulting in the unintentional disclosure of customer or Company information. Management has taken steps to address these concerns for its own systems by implementing sophisticated network security and internal control measures. However, there can be no assurance that a system

Source: APPLE COMPUTER INC, 10-Q, February 03, 2006

failure or data security breach of the Company or a third-party vendor will not have a material adverse effect on the Company's results of operations.

The Company's business is subject to the risks of international operations.
A large portion of the Company's revenue is derived from its international operations. As a result, the Company's operating results and financial condition could be significantly affected by risks associated with international activities, including economic and labor conditions, political instability, tax laws (including U.S. taxes on foreign subsidiaries), and changes in the value of the U.S. dollar versus the local currency in which the products are sold and goods and services are purchased. The Company's primary exposure to movements in foreign currency exchange rates relate to non-dollar denominated sales in Europe, Japan, Australia, Canada, and certain parts of Asia and non-dollar denominated operating expenses incurred throughout the world. Weaknesses in foreign currencies, particularly the Japanese Yen and the Euro, can adversely impact consumer demand for the Company's products and the U.S. dollar value of the Company's foreign currency denominated sales. Conversely, a strengthening in these and other foreign currencies can cause the Company to modify international pricing and affect the value of the Company's foreign denominated sales, and in some cases, may also increase the cost to the Company of some product components.

Margins on sales of the Company's products in foreign countries, and on sales of products that include components obtained from foreign suppliers, can be adversely affected by foreign currency exchange rate fluctuations and by international trade regulations, including tariffs and antidumping penalties.

Derivative instruments, such as foreign exchange forward and option positions have been utilized by the Company to hedge exposures to fluctuations in foreign currency exchange rates. The use of such hedging activities may not offset more than a portion of the adverse financial impact resulting from unfavorable movements in foreign exchange rates.

Further information related to the Company's global market risks may be found in Part II, Item 7A of the 2005 Form 10-K for the year ended September 24, 2005 under the subheading "Foreign Currency Risk" and may be found in Part II, Item 8 of the 2005 Form 10-K for the year ended September 24, 2005 at Notes 1 and 2 of Notes to Consolidated Financial Statements.

The Company is subject to risks associated with environmental regulations.
Production and marketing of products in certain states and countries may subject the Company to environmental and other regulations including, in some instances, the requirement to provide customers the ability to return product at the end of its useful life, and place responsibility for environmentally safe disposal or recycling with the Company. Such laws and regulations have recently been passed in several jurisdictions in which the Company operates, including various European Union member countries, Japan, and certain states within the U.S. In the future, these laws could have a material adverse effect on the Company's results of operations.

Changes in accounting rules could affect the Company's future operating results.
Financial statements are prepared in accordance with U.S. generally accepted accounting principles. These principles are subject to interpretation by various governing bodies, including the FASB and the SEC, who create and interpret appropriate accounting standards. A change from current accounting standards could have a significant effect on the Company's results of operations. In December 2004, the FASB issued new guidance that addresses the accounting for share-based payments, SFAS No. 123R, which the Company adopted in the first quarter of 2006. In the first quarter of 2006, stock-based compensation expense reduced diluted earnings per common share by approximately $0.03. Although the effect from the adoption of SFAS No. 123R is expected to continue to have a material impact on the Company's results of operations, future changes to various assumptions used to determine the fair-value of awards issued or the amount and type of equity awards granted create uncertainty as to the amount of future stock-based compensation expense.

Changes in the Company's tax rates could affect its future results.
The Company's future effective tax rates could be favorably or unfavorably affected by changes in the mix of earnings in countries with differing statutory tax rates, changes in the valuation of the Company's deferred tax assets and liabilities, or by changes in tax laws or their interpretation. In addition, the Company is subject to the continuous examination of its income tax returns by the Internal Revenue Service and other tax authorities. The Company regularly assesses the likelihood of adverse outcomes resulting from these examinations to determine the adequacy of

Source: APPLE COMPUTER INC, 10-Q, February 03, 2006

its provision for income taxes. There can be no assurance that the outcomes from these continuous examinations will not have an adverse affect on the Company's results of operations and financial condition.

The Company's stock price may be volatile.
The Company's stock has at times experienced substantial price volatility as a result of variations between its actual and anticipated financial results and as a result of announcements by the Company and its competitors. The stock market has experienced extreme price and volume fluctuations that have affected the market price of many technology companies in ways that may have been unrelated to the operating performance of these companies. Furthermore, the Company believes its stock price reflects high future growth and profitability expectations. If the Company fails to meet these expectations its stock price may significantly decline. These factors, including lack of positive general economic and political conditions and investors' concerns regarding the credibility of corporate financial reporting and integrity of financial markets, may materially adversely affect the market price of the Company's stock in the future. In addition, increases in the Company's stock price may result in greater dilution of earnings per share.

For a discussion of these and other factors affecting the Company's future results and financial condition, see Item 7, "Management's Discussion and Analysis – Factors That May Affect Future Results and Financial Condition" and Item 1, "Business" in the Company's 2005 Form 10-K.

Source: APPLE COMPUTER INC, 10-Q, February 03, 2006

Item 3. Quantitative and Qualitative Disclosures About Market Risk
The Company's market risk profile has not changed significantly from that described in the 2005 Form 10–K.

Interest Rate and Foreign Currency Risk Management
The Company regularly reviews its foreign exchange forward and option positions and its interest rate swap and option positions, both on a stand–alone basis and in conjunction with its underlying foreign currency and interest rate related exposures. However, given the effective horizons of the Company's risk management activities and the anticipatory nature of the exposures, there can be no assurance the hedges will offset more than a portion of the financial impact resulting from movements in either foreign exchange or interest rates. In addition, the timing of the accounting for recognition of gains and losses related to mark–to–market instruments for any given period may not coincide with the timing of gains and losses related to the underlying economic exposures and, therefore, may adversely affect the Company's operating results and financial position.

Interest Rate Risk
While the Company is exposed to interest rate fluctuations in many of the world's leading industrialized countries, the Company's interest income and expense is most sensitive to fluctuations in the general level of U.S. interest rates. In this regard, changes in U.S. interest rates affect the interest earned on the Company's cash, cash equivalents, and short–term investments as well as costs associated with foreign currency hedges.

The Company's short–term investment policy and strategy is to ensure the preservation of capital, meet liquidity requirements, and optimize return in light of the current credit and interest rate environment. The Company benchmarks its performance by utilizing external money managers to manage a small portion of the aggregate investment portfolio. The external managers adhere to the Company's investment policies and also provide occasional research and market information that supplements internal research used to make credit decisions in the investment process.

The Company's exposure to market risk for changes in interest rates relates primarily to the Company's investment portfolio. The Company places its short–term investments in highly liquid securities issued by high credit quality issuers and, by policy, limits the amount of credit exposure to any one issuer. The Company's general policy is to limit the risk of principal loss and ensure the safety of invested funds by limiting market and credit risk. All highly liquid investments with maturities of three months or less are classified as cash equivalents; highly liquid investments with maturities greater than three months are classified as short–term investments. As of December 31, 2005, approximately $172 million of the Company's short–term investments had underlying maturities ranging from one to five years. The remainder all had underlying maturities between three and 12 months. The Company may sell its investments prior to their stated maturities for strategic purposes, in anticipation of credit deterioration, or for duration management. The Company recognized no material net gains or losses during the first quarter of 2006 or 2005 related to such sales.

Foreign Currency Risk
In general, the Company is a net receiver of currencies other than the U.S. dollar. Accordingly, changes in exchange rates, and in particular a strengthening of the U.S. dollar, may negatively affect the Company's net sales and gross margins as expressed in U.S. dollars. There is also a risk that the Company will have to adjust local currency product pricing due to competitive pressures when there has been significant volatility in foreign currency exchange rates.

The Company may enter into foreign currency forward and option contracts with financial institutions to protect against foreign exchange risks associated with existing assets and liabilities, certain firmly committed transactions, forecasted future cash flows, and net investments in foreign subsidiaries. Generally, the Company's practice is to hedge a majority of its existing material foreign exchange transaction exposures. However, the Company may not hedge certain foreign exchange transaction exposures due to immateriality, prohibitive economic cost of hedging particular exposures, and limited availability of appropriate hedging instruments.

Source: APPLE COMPUTER INC, 10-Q, February 03, 2006

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Based on an evaluation under the supervision and with the participation of the Company's management, the Company's principal executive officer and principal financial officer have concluded that the Company's disclosure controls and procedures as defined in rules 13a–15(e) and 15d–15(e) under the Securities Exchange Act of 1934, as amended (Exchange Act) were effective as of December 31, 2005 to ensure that information required to be disclosed by the Company in reports that it files or submits under the Exchange Act is (i) recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission rules and forms and (ii) accumulated and communicated to the Company's management, including its principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

Changes in Internal Control Over Financial Reporting

There were no significant changes in the Company's internal control over financial reporting identified in management's evaluation during the first quarter of 2006 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

The Company is subject to various legal proceedings and claims that are discussed below. The Company is also subject to certain other legal proceedings and claims that have arisen in the ordinary course of business and which have not been fully adjudicated. In the opinion of management, the Company does not have a potential liability related to any current legal proceedings and claims that would individually or in the aggregate have a material adverse effect on its financial condition, liquidity or results of operations. However, the results of legal proceedings cannot be predicted with certainty. Should the Company fail to prevail in any of these legal matters or should several of these legal matters be resolved against the Company in the same reporting period, the operating results of a particular reporting period could be materially adversely affected. The Company settled certain matters during the first quarter of 2006 that did not individually or in the aggregate have a material impact on the Company's results of operations.

Allen v. Apple Computer, Inc.

On January 28, 2005 a plaintiff, filed a purported nationwide class action in Los Angeles Superior Court alleging that a defect in the Company's 17–inch Studio Display monitors results in dimming of half of the screen and constant blinking of the power light. Plaintiff filed an amended complaint on October 24, 2005, adding additional named plaintiffs and expanding the alleged class to include purchasers of the 20–inch Apple Cinema Display and the 23–inch Apple Cinema HD Display. The amended complaint alleges that the displays have a purported defect that causes dimming of one–half of the screen, and that the Company misrepresented the quality of the displays and/or concealed the purported defect. Plaintiffs assert claims under California Business & Professions Code §17200 (unfair competition); California Business & Professions Code §17500 (false advertising) and the Consumer Legal Remedies Act. The amended complaint seeks remedies including damages and equitable relief. On November 14, 2005, the Company filed an answer to the amended complaint as to the allegations regarding the 17–inch display and a demurrer/motion to strike as to the allegations regarding the 20–inch and 23–inch displays on the ground that plaintiffs failed to allege that they purchased those displays. At a status conference on November 1, 2005, the Court ordered Plaintiffs to amend their complaint. Plaintiff filed an amended complaint on December 12, 2005, and the Company answered on January 5, 2006 denying all allegations and asserting numerous affirmative defenses. The case is in discovery.

Apple Computer, Inc. v. Burst.com. Inc

The Company filed an action for declaratory judgment against Defendant Burst.com, Inc. on January 4, 2006. The Company seeks declaratory judgment that U.S. Patent Nos. 4,963,995, 5,164,839, and 5,995,705 are invalid and not infringed by the Company. The patents allegedly relate to methods and devices used for "burst" transmission of audio or video files. Burst.com has claimed that iTunes, iTunes Music Store, iPod, Airport Express, and Quicktime infringe the patents.

Apple Corps Ltd. v. Apple Computer, Inc.; Apple Computer, Inc. v. Apple Corps Ltd.

Plaintiff Apple Corps filed this action on July 4, 2003 in the High Court of Justice, Chancery Division, in London alleging that the Company has breached a 1991 agreement that resolved earlier trademark litigation between the

Source: APPLE COMPUTER INC, 10-Q, February 03, 2006

parties regarding use of certain Apple marks. Plaintiff seeks an injunction, unspecified damages, and other relief. The Company filed a motion on October 13, 2003, challenging jurisdiction in the U.K. The Court denied this motion on April 7, 2004. The Company filed an appeal of the Court's decision but subsequently withdrew the appeal. In November 2004, Plaintiff served the Company with an Amended Bill of Particulars and on December 23, 2004, the Company filed a Defence. On November 24, 2005, Plaintiff filed a Re–Amended Bill of Particulars and the Company filed its Defence on December 16, 2005. Trial is set for the week of March 27, 2006.

On October 8, 2003, the Company filed a lawsuit against Apple Corps in the United States District Court for the Northern District of California requesting a declaratory judgment that the Company has not breached the 1991 agreement. Apple Corps challenged jurisdiction in the California case but the Court denied that challenge on March 25, 2004. Apple Corps subsequently prevailed on a motion to stay the California case during the pendency of the U.K. action. The Company has dismissed the California lawsuit without prejudice.

Bader v. Anderson; Bader v. Apple Computer, Inc. et. al.
Plaintiff filed this purported shareholder derivative action against the Company and each of its current executive officers and members of its Board of Directors on May 19, 2005 in Santa Clara County Superior Court asserting claims for breach of fiduciary duty, material misstatements and omissions, and violations of California Businesses and Professions Code §17200 (unfair competition). Plaintiff alleges that the Company's March 14, 2005, proxy statement was false and misleading for failure to disclose certain information relating to the Apple Computer, Inc. Performance Bonus Plan, which was approved by shareholders at the annual meeting held on April 21, 2005. Plaintiff, who ostensibly brings suit on the Company's behalf, has made no demand on the Board of Directors and alleges that such demand is excused. Plaintiff seeks injunctive and other relief for purported injury to the Company. On July 27, 2005, Plaintiff filed an amended complaint alleging that, in addition to the purported derivative claims, adoption of the bonus plan and distribution of the proxy statement describing that plan also inflicted injury on her directly as an individual shareholder. Defendants filed a demurrer. On January 10, 2006, the court sustained defendants' demurrer and gave the Plaintiff 30 days to amend her complaint.

Baghdasarian, et al. v. Apple Computer, Inc.
Plaintiffs filed this action in Los Angeles County Superior Court on October 31, 2005, on behalf of a purported nationwide class of all purchasers of all Apple wireless products (router, modem, or adaptor) sold at any time. The complaint alleges that the Company misrepresented the transmission rates of these products. The complaint alleges causes of action for breach of express warranty and for violations of the Consumer Legal Remedies Act, California Business & Professions Code §17200 (unfair competition) and California Business & Professions Code §17500 (false advertising). The complaint seeks damages and equitable remedies. The Company filed an answer denying all allegations and asserting numerous affirmative defenses to the complaint on December 15, 2005.

Birdsong v. Apple Computer, Inc. (filed January 30, 2006, United States District Court for the Western District of Louisiana);
Patterson v. Apple Computer, Inc. (filed January 31, 2006, United States District Court for the Northern District of California)
These federal court complaints allege that the Company's iPod music players, and the ear bud headphones sold with them, are inherently defective in design and are sold without adequate warnings concerning the risk of noise–induced hearing loss by iPod users. The *Birdsong* action was brought on behalf of a purported Louisiana class of iPod purchasers and alleges violations of the Louisiana Products Liability Act, breaches of implied warranties, unjust enrichment and negligent misrepresentation. The *Patterson* action was brought on behalf of a purported class of all iPod purchasers within the four year period before January 31, 2006. That action alleges breaches of implied and express warranties, violations of California Business & Professions Code §17200 (unfair competition), California Business & Professions Code §17500 (false advertising), California Civil Code §1750 (Consumer Legal Remedies Act), breaches of express and implied warranties, negligent misrepresentation and unjust enrichment. The Company has not yet been served with these actions and the Company's responses to these complaints are not yet due.

A similar complaint, *Royer–Brennan v. Apple Computer, Inc. and Apple Canada, Inc.*, was filed in Montreal, Quebec, Canada, on February 1, 2006, seeking authorization to institute a class action on behalf of iPod purchasers in Quebec.

Branning et al. v. Apple Computer, Inc.
Plaintiffs originally filed this purported class action in San Francisco County Superior Court on February 17, 2005. The initial complaint alleged violations of California Business & Professions Code §17200 (unfair competition) and violation of the Consumer Legal Remedies Act (CLRA) regarding a variety of purportedly unfair and unlawful conduct including, but not limited to, allegedly selling used computers as new and failing to honor warranties. Plaintiffs also brought causes of action for misappropriation of trade secrets, breach of contract, and violation of the Song Beverly Act. Plaintiffs requested unspecified damages and other relief. On May 9, 2005, the Court granted the Company's motion to transfer the case to Santa Clara County Superior Court. On May 2, 2005, Plaintiffs filed an amended complaint adding two new named plaintiffs and three new causes of action including a claim for treble damages under the Cartwright Act (California Business and Professions Code §16700 et seq.) and a claim for false advertising. The Company filed a demurrer to the amended complaint, which the Court sustained in its entirety on November 10, 2005. The Court granted Plaintiffs leave to amend and they filed an amended complaint on December 29, 2005. Plaintiffs' amended complaint adds three additional plaintiffs and alleges many of the same factual claims as the previous complaints such as alleged selling of used equipment as new, alleged failure to honor warranties and service contracts for the consumer plaintiffs, and alleged fraud related to the opening of the Apple Retail stores. Plaintiffs continue to assert causes of action for unfair competition (§17200), violations of the CLRA, breach of contract, misappropriation of trade secrets, violations of the Cartwright Act and allege new causes of action for fraud, conversion and breach of the implied covenant of good faith and fair dealing. The Company filed a demurrer to the amended

complaint on January 31, 2006.

Source: APPLE COMPUTER INC, 10-Q, February 03, 2006

Butzer, et al., v. Apple Computer, Inc./Wirges v. Apple Computer, Inc.
Plaintiffs filed the Butzer action on August 23, 2005, in the United States District Court for the Northern District of California, San Jose Division, on behalf of a purported nationwide class of all purchasers of the Company's PowerBook G4 portable computers. The complaint alleges defects in the memory of the computers. The complaint alleges that this purported defect extends to other series of the Company's portables and states that plaintiffs reserve the right to amend the complaint to include these other series. Plaintiffs assert claims for alleged violations of California Business & Professions Code §17200 (unfair competition), California Business & Professions Code §17500 (false advertising), the Consumer Legal Remedies Act and the Song–Beverly Consumer Warranty Act. The complaint seeks remedies including restitution and/or damages and injunctive relief. The Wirges action was filed on January 20, 2006 in the United State District Court for the Eastern District of Arkansas, also on behalf of a purported nationwide class, and makes similar allegations. Plaintiffs assert claims for breach of warranties, violation of Magnuson–Moss Act, strict products liability and unjust enrichment. The complaint seeks restitution, damages and other remedies. The Company filed an answer to the Butzer complaint on October 19, 2005 denying the material allegations and asserting numerous affirmative defenses. A class certification hearing is set for June 23, 2006. The case is in discovery. The Company's response to the Wirges action is not yet due.

Cagney v. Apple Computer, Inc.
Plaintiff filed this purported class action on January 9, 2004 in Los Angeles County Superior Court, alleging improper collection of sales tax in transactions involving mail–in rebates. The complaint alleged violations of California Business and Professions Code §17200 (unfair competition) and sought restitution and other relief. The Company filed an answer on February 20, 2004, denying all allegations and asserting numerous affirmative defenses. The Company filed a motion to disqualify Plaintiff's counsel, which the Court denied. The Company filed a petition for a writ of mandate with respect to this ruling and the Court of Appeal issued an order to show cause as to why the writ should not issue. Plaintiff's lead counsel subsequently withdrew. On February 17, 2005 the Court of Appeal ruled that the trial court abused its discretion in failing to grant the Company's motion to disqualify and ordered the trial court to disqualify both of Plaintiff's law firms upon remand. The trial court issued the disqualification order on May 12, 2005. On May 9, 2005 Plaintiff substituted new counsel. The Company has obtained an opinion on the tax issue from the State Board of Equalization. The parties have reached a settlement and the matter is concluded. Settlement of this case did not have a material effect on the Company's financial position or results of operation.

Clark v. Apple Computer, Inc.
Plaintiff filed this purported class action on February 2, 2005 in Santa Clara County Superior Court alleging defects in the Company's "yo–yo" power adapters. Plaintiffs requested unspecified damages and other relief. The parties reached a tentative settlement in this matter. The Court granted preliminary approval of the settlement on April 19, 2005 and on January 10, 2006, the Court gave final approval of the settlement. The matter is concluded. Settlement of this matter did not have a material effect on the Company's financial position or results of operation.

Compression Labs, Inc. v. Apple Computer, Inc., et al.; Apple v. Compression Labs, Inc., et al.
Plaintiff Compression Labs, Inc. filed this patent infringement action on April 22, 2004 against the Company and twenty–seven other defendants in the United States District Court for the Eastern District of Texas, Marshall Division, alleging infringement of U.S. patent 4,698,672 (the '672 patent). Plaintiff alleges that the Company infringes the patent by complying with the JPEG standard as defined by CCITT Recommendation T.81 entitled "Information Technology—Digital Compression and Coding of Continuous Tone Still Images—Requirements and Guidelines." Plaintiff seeks unspecified damages and other relief.

On July 2, 2004, the Company and several other defendants in the Texas action filed a lawsuit in the United States District Court in Delaware against Compression Labs, Inc. and two other companies, requesting a declaratory judgment of non–infringement, invalidity, implied license, and unenforceability with respect to the '672 patent. Additional actions regarding this patent have been filed in other jurisdictions. On February 16, 2005, the Panel on Multi–District Litigation (MDL) granted a petition filed by certain defendants, seeking coordination and transfer of all of these cases to one court for pre–trial proceedings. The MDL Panel has transferred all of the cases to the Northern District of California. The defendants in the Texas and Delaware actions had filed motions to dismiss prior to the transfer and both motions are still pending. A Markman hearing is set for February 13, 2006.

Contois Music Technology LLC v. Apple Computer, Inc.
Plaintiff Contois Music Technology ("Contois") filed this action on June 13, 2005 in the United States District Court for Vermont, alleging infringement by the Company of U.S. Patent No. 5,864,868, entitled "Computer Control System and User Interface for Media Playing Devices." The complaint, which was served on October 4, 2005, seeks

Source: APPLE COMPUTER INC, 10-Q, February 03, 2006

unspecified damages and other relief. The Company filed an answer on November 23, 2005 denying all material allegations and asserting numerous affirmative defenses.

Craft v. Apple Computer, Inc. (filed December 23, 2003, Santa Clara County Superior Court); *Chin v. Apple Computer, Inc.* (filed December 23, 2003, San Mateo County Superior Court); *Hughes v. Apple Computer, Inc.* (filed December 23, 2003, Santa Clara County Superior Court); *Westley v. Apple Computer, Inc.* (filed December 26, 2003, San Francisco County Superior Court); *Keegan v. Apple Computer, Inc.* (filed December 30, 2003, Alameda County Superior Court); *Wagya v. Apple Computer, Inc.* (filed February 19, 2004, Alameda County Superior Court); *Yamin v. Apple Computer, Inc.* (filed February 24, 2004, Los Angeles County Superior Court); *Kieta v. Apple Computer, Inc.* (filed July 8, 2004, Alameda County Superior Court); *Mosley v. Apple Computer, Inc.* (filed June 23, 2004, Westchester County, NY)
Eight separate plaintiffs filed purported class action cases in various California courts alleging misrepresentations by the Company relative to iPod battery life. The complaints include causes of action for violation of California Business and Professions Code §17200 (unfair competition), the Consumer Legal Remedies Action and claims for false advertising, fraudulent concealment, and breach of warranty. The complaints sought unspecified damages and other relief. The cases were consolidated in San Mateo County and Plaintiffs thereafter filed a consolidated complaint. On August 25, 2004, the Company filed an answer denying all allegations and asserting numerous affirmative defenses. A similar complaint relative to iPod battery life, *Mosley v. Apple Computer, Inc.*, was filed in Westchester County, New York on June 23, 2004 alleging violations of New York General Business Law Sections 349 (unfair competition) and 350 (false advertising). This case was stayed. The parties reached a tentative settlement of all cases, and the court granted preliminary approval of the settlement on May 20, 2005. The court entered an order granting final approval to the settlement on August 25, 2005. An appeal challenging the trial court's approval of the settlement was filed on October 24, 2005, but was subsequently withdrawn. The settlement is now final. Settlement of this matter will not have a material effect on the Company's financial position or results of operations.

A similar complaint related to the iPod battery life, *Lenzi v. Apple Canada, Inc.* was filed in Montreal, Quebec, Canada, on June 7, 2005, seeking authorization to institute a class action on behalf of Generations 1, 2 and 3 iPod owners in Quebec. On February 2, 2006, the Court dismissed plaintiff's motion for authorization to institute a class action (motion for certification).

Two similar complaints relative to iPod battery life, *Wolfe v. Apple* and *Hirst v. Apple*, were filed in Toronto, Ontario, Canada on August 15, 2005 and September 12, 2005, respectively. Both actions define the purported class as a national class consisting of all persons in Canada who have purchased or who own an iPod. A motion for certification of the class proceeding has been scheduled for the Spring of 2006.

Davis v. Apple Computer, Inc.
Plaintiff filed this purported class action in San Francisco County Superior Court on December 5, 2002, alleging that the Company engaged in unfair and deceptive business practices relating to its AppleCare Extended Service and Warranty Plan. Plaintiff asserts causes of action for violation of California Business & Professions Code §17200 (unfair competition), California Business & Professions Code §17500 (false advertising), breach of the Song–Beverly Warranty Act, intentional misrepresentation and concealment. Plaintiff requests unspecified damages and other relief. The Company filed a demurrer and motion to strike which were granted, in part, and Plaintiff filed an amended complaint. The Company filed an answer on April 17, 2003 denying all allegations and asserting numerous affirmative defenses. Plaintiff subsequently amended its complaint. On October 29, 2003, the Company filed a motion to disqualify Plaintiff's counsel in his role as counsel to the purported class and to the general public. The Court granted the motion but allowed Plaintiff to retain substitute counsel. Plaintiff did engage new counsel for the general public, but not for the class. The Company moved to disqualify Plaintiff's new counsel and to have the Court dismiss the general public claims for equitable relief. The Court declined to disqualify Plaintiff's new counsel or to dismiss the equitable claims, but did confirm that the class action claims are dismissed. The Company appealed the ruling and the case was stayed pending the outcome of the appeal. The Court of Appeal denied the appeal on August 17, 2005, affirming the trial court's decision. The Company filed a Petition for review with the California Supreme Court, which was denied on November 23, 2005.

European Commission Investigation
The European Commission has notified the Company that it is investigating certain matters relating to the iTunes Music Store in the European Union (EU). The European Commission is investigating claims made by Which?, a United Kingdom (UK) consumer association, that the Company is violating EU competition law by charging more

Source: APPLE COMPUTER INC, 10-Q, February 03, 2006

for online music in the UK than in Eurozone countries and preventing UK consumers from purchasing online music from the iTunes Music Store for Eurozone countries. The Which? claims were originally lodged with the UK Office of Fair Trading, which subsequently referred them to the European Commission. The European Commission is investigating the charges under Articles 81 and 82 of the European Commission Treaty.

Gillis et al. v. Apple Computer, Inc.
Plaintiffs filed this purported class action on December 23, 2005 in San Diego County Superior Court alleging that the Company has misrepresented the hard drive capacity of two Powerbook G4 computers: the 12 inch, 1.5 GHz computer with 512 MB of memory and a 100GB hard drive; and the 15 inch, 1.67 GHz computer with 1GB of memory and 100GB hard drive. Plaintiffs allege that the Company's standard disclosure on its packaging regarding hard drive size was not present on the packaging for these two models. The complaint alleges violations of the California Business & Profession Code sections §17200 (unfair competition), California Business & Profession Code §17500 (false advertising), the Consumer Legal Remedies Act, and causes of action for deceit and negligent misrepresentation. Plaintiffs seek restitution and other relief. The Company's response is not yet due.

Gobeli Research Ltd. v. Apple Computer, Inc., et al.
Plaintiff Gobeli Research Ltd. filed this patent infringement action against the Company and Sun Microsystems, Inc. on April 15, 2004 in the United States District Court for the Eastern District of Texas, Marshall Division, alleging infringement of U.S. patent 5,418,968 related to a "System and Method of Controlling Interrupt Processing." Plaintiff alleged that the Company's Mac OS 9 and Mac OS X operating systems infringe Plaintiff's patent. Plaintiff sought unspecified damages and other relief. The Company filed an answer on June 9, 2004, denying all material allegations and asserting numerous affirmative defenses. The Company also asserted counterclaims requesting declaratory judgment of non-infringement and invalidity. A Markman hearing took place August 9, 2005, and the Court issued a ruling on August 26, 2005 invalidating one of Plaintiff's two claims. On October 18, 2005, a Stipulation entered into by the parties was filed removing Mac OS 9 from the case. The case settled and was dismissed on January 13, 2006. Settlement of this matter did not have a material effect on the Company's financial position or results of operations.

Goldberg, et al. v. Apple Computer, Inc., et al. (f.k.a. "Dan v. Apple Computer, Inc.")
Plaintiffs filed this purported class action on September 22, 2003 in Los Angeles County Superior Court against the Company and other members of the computer industry on behalf of an alleged nationwide class of purchasers of certain computer hard drives. The case alleges violations of California Business and Professions Code §17200 (unfair competition), the Consumer Legal Remedies Act and false advertising related to the size of the drives. Plaintiffs allege that calculation of hard drive size using the decimal method misrepresents the actual size of the drive. The complaint seeks restitution and other relief. Plaintiff filed an amended complaint on March 30, 2004 and the Company filed an answer on September 23, 2004, denying all allegations and asserting numerous affirmative defenses. Defendants filed a motion to strike portions of the complaint based on sales by resellers and filed a motion for judgment on the pleadings based upon Proposition 64. The Court granted both motions at a hearing on April 6, 2005. Plaintiff thereafter filed an amended complaint on May 6, 2005. The Defendants filed a demurrer on June 6, 2005, which was heard on August 22, 2005. The Court granted the demurrer in part and denied it in part. Plaintiff filed an amended complaint and the Company filed an answer on December 15, 2005 denying all allegations and asserting numerous assertive defenses.

Honeywell International, Inc., et al. v. Apple Computer, Inc., et al.
Plaintiffs Honeywell International, Inc. and Honeywell Intellectual Properties, Inc. filed this action on October 6, 2004 in the United States District Court in Delaware alleging infringement by the Company and other defendants of U.S. patent 5,280,371 entitled "Directional Diffuser for a Liquid Crystal Display." Plaintiffs seek unspecified damages and other relief. The Company filed an answer on December 21, 2004 denying all material allegations and asserting numerous affirmative defenses. The Company has tendered the case to several suppliers. On May 18, 2005 the Court stayed the case against the Company and the other supplier defendants. Plaintiffs filed an amended complaint on November 7, 2005 adding additional defendants and expanding the scope of the accused products. Given the stay, the Company's response to the amended complaint is not yet due.

Source: APPLE COMPUTER INC, 10-Q, February 03, 2006

MacTech Systems v. Apple Computer, Inc.; Macadam v. Apple Computer, Inc.; Computer International, Inc. v. Apple Computer, Inc.; Elite Computers and Software, Inc. v. Apple Computer, Inc.; The Neighborhood Computer Store v. Apple Computer, Inc. MacAccessory Center, Inc. v. Apple Computer, Inc.; MacAccessory Center, Inc. v. Apple Computer, Inc. (all in Santa Clara County Superior Court)
Six resellers filed similar lawsuits against the Company between late 2002 and early 2005 for various causes of action including breach of contract, fraud, negligent and intentional interference with economic relationship, negligent misrepresentation, trade libel, unfair competition and false advertising. Plaintiffs request unspecified damages and other relief. The Company answered the Computer International complaint on November 12, 2003, denying all allegations and asserting numerous affirmative defenses. The Company filed an answer in the Macadam case on December 3, 2004 denying all allegations and asserting numerous defenses. Three of the other plaintiffs filed amended complaints on February 7, 2005, and on March 16, 2005 the Company filed answers to these claims denying all allegations and asserting numerous affirmative defenses. A sixth Plaintiff, MacAccessory Center, filed a complaint on February 23, 2005. The Company filed an answer to this complaint on April 20, 2005 denying all allegations and asserting numerous affirmative defenses. All of these cases with the exception of Macadam are in discovery and are coordinated (along with the Branning class action) in Santa Clara Superior Court. The cases (except Branning) are set for trial on November 27, 2006. On December 19, 2005, Tom Santos, Macadam's principal and an original plaintiff in the Macadam case, filed a Fifth Amended Complaint on his own behalf (not on behalf of Macadam) alleging fraud, violations of California Business & Professional Code §17200 (unfair competition), California Business & Professional Code §17500 (false advertising) and the Consumer Legal Remedies Act. The Company filed a demurrer to Santos' amended complaint and a special motion to strike the defamation cause of action on January 20, 2006. A hearing is scheduled for February 17, 2006. The Company also filed a cross complaint against Santos on January 20, 2006 alleging violations of California Business & Professional Code §17200, fraud and deceit, breach of contract, and violation of California Penal Code §502.

On October 1, 2003, one of the reseller Plaintiffs, Macadam, was deauthorized as an Apple reseller. Macadam filed a motion for a temporary order to reinstate it as a reseller, which the Court denied. The Court denied Macadam's motion for a preliminary injunction on December 19, 2003. On December 6, 2004 Macadam filed for Chapter 11 Bankruptcy in the Northern District of California, which placed a stay on the litigation as to Macadam only. The Company filed a claim in the bankruptcy proceedings on February 16, 2005. The Macadam bankruptcy case was converted to Chapter 7 (liquidation) on April 29, 2005. The Company has reached a tentative settlement of the Macadam case with the Chapter 7 Bankruptcy Trustee. The parties await approval of that settlement by the Bankruptcy Court.

Macsolutions Inc. v. Apple Computer, Inc.
Plaintiff Macsolutions, Inc., an Apple authorized reseller, filed this lawsuit against the Company on January 20, 2006 alleging breach of contract, fraud, misappropriation of trade secrets, intentional interference with economic advantage, violation of the Cartwright Act, violation of California Business & Professions Code §17200 (unfair business practices) and fraudulent concealment. The factual allegations in this complaint are similar to those in the six other reseller cases and the Branning class action. Principally, Plaintiffs allege that the Company has treated Macsolutions unfairly compared to other resellers, that the Company has competed unfairly in opening the Apple Retail stores, and has allegedly sold used goods as new. The Company's response is not yet due.

Premier International Associates LLC v. Apple Computer, Inc.
Plaintiff Premier International Associates LLC filed this action on November 3, 2005 in the United States District Court for the Eastern District of Texas, Marshall Division, alleging infringement by the Company of U.S. Patents 6,243,725 and 6,763,345 both entitled "List Building System." The complaint seeks unspecified damages and other relief. The Company filed an answer on January 13, 2006 denying all material allegations and asserting numerous affirmative defenses. The Company also asserted counter claims for a declaratory judgment of noninfringement and invalidity.

Slattery v. Apple Computer, Inc.
Plaintiff filed this purported class action on January 3, 2005 in the United States District Court for the Northern District of California alleging various claims including alleged unlawful tying of music purchased on the iTunes Music Store with the purchase of iPods and vice versa and unlawful acquisition or maintenance of monopoly market power. Plaintiff's complaint alleged violations of §§1 and 2 of the Sherman Act (15 U.S.C. §§1 and 2), California Business and Professions Code §16700 et seq. (the Cartwright Act), California Business and Professions Code §17200 (unfair competition), common law unjust enrichment and common law monopolization. Plaintiff seeks unspecified damages and other relief. The Company filed a motion to dismiss on February 10, 2005. On September 9, 2005, the Court denied the motion in part and granted it in part. Plaintiff filed an amended complaint on September 23, 2005 and the Company filed an answer on October 11, 2005. The case is in discovery.

St-Germain v. Apple Canada, Inc.
Plaintiff filed this case in Montreal, Quebec, Canada, on August 5, 2005, seeking authorization to institute a class action for the refund by the Company of the Canadian Private Copying Levy that was applied to the iPod purchase price in Quebec between December 12, 2003 and December 14, 2004 but later declared invalid by the Canadian Court. A class certification hearing took place January 13, 2006 and the Company awaits a ruling. The Company is in the process of completing a refund program for this levy.

Source: APPLE COMPUTER INC, 10-Q, February 03, 2006

month of a quarter and may adversely impact the Company's ability to predict its financial results accurately. Furthermore, the Company has typically experienced greater net sales in the first and fourth fiscal quarters compared to other quarters in the fiscal year due to seasonal demand related to the holiday season and the beginning of the school year. Developments late in a quarter, such as lower-than-anticipated demand for the Company's products, an internal systems failure, or failure of one of the Company's key logistics, components suppliers, or manufacturing partners, can have significant adverse impacts on the Company and its results of operations and financial condition.

The Company has higher research and development and selling, general and administrative costs, as a percentage of revenue, than many of its competitors.
The Company's ability to compete successfully and maintain attractive gross margins and revenue growth is heavily dependent upon its ability to ensure a continuing and timely flow of innovative and competitive products and technologies to the marketplace. As a result, the Company generally incurs higher research and development costs as a percentage of revenue than its competitors who sell personal computers based on other operating systems. Many of these competitors seek to compete aggressively on price and maintain very low cost structures. Further, as a result of the expansion of the Company's Retail segment and costs associated with marketing the Company's brand including its unique operating system, the Company incurs higher selling costs as a percentage of revenue than many of its competitors. If the Company is unable to continue to develop and sell innovative new products with attractive gross margins, its results of operations may be materially adversely affected by its operating cost structure.

The Company is exposed to credit risk on its accounts receivable and prepayments related to long-term supply agreements. This risk is heightened during periods when economic conditions worsen.
The Company distributes its products through third-party computer resellers and retailers and directly to certain educational institutions and commercial customers. A substantial majority of the Company's outstanding trade receivables are not covered by collateral or credit insurance. The Company also has unsecured non-trade receivables from certain of its manufacturing vendors resulting from the sale by the Company of raw material components to these manufacturing vendors who manufacture sub-assemblies or assemble final products for the Company. In addition, the Company has entered into long-term supply agreements to secure supply of NAND flash-memory and has prepaid a total of $1.25 billion under these agreements. While the Company has procedures in place to monitor and limit exposure to credit risk on its trade and non-trade receivables as well as long-term prepayments, there can be no assurance that such procedures will be effective in limiting its credit risk and avoiding losses. Additionally, if the global economy and regional economies fail to improve or continue to deteriorate, it becomes more likely that the Company will incur a material loss or losses as a result of the weakening financial condition of one or more of its customers or manufacturing vendors.

The Company's success depends largely on its ability to attract and retain key personnel.
Much of the future success of the Company depends on the continued service and availability of skilled personnel, including its Chief Executive Officer, members of its executive team, and those in technical, marketing and staff positions. Experienced personnel in the information technology industry are in high demand and competition for their talents is intense, especially in the Silicon Valley, where the majority of the Company's key employees are located. The Company has relied on its ability to grant stock options as one mechanism for recruiting and retaining this highly skilled talent. Recent accounting regulations requiring the expensing of stock options have resulted in increased stock-based compensation expense, which may cause the Company to reduce the amount of stock-based awards issued to employees. There can be no assurance that the Company will continue to successfully attract and retain key personnel.

The Company is subject to risks associated with the selection, availability, and cost of insurance.
The Company has observed rapidly changing conditions in the insurance markets relating to nearly all areas of traditional commercial insurance. Such conditions have and may continue to result in higher premium costs, higher policy deductibles, lower coverage limits and may also yield possible policy form exclusions. For some risks, because of cost and/or availability, the Company does not have insurance coverage. Because the Company retains some portion of its insurable risks, and in some cases self insures completely, unforeseen or catastrophic losses in excess of insured limits may have a material adverse effect on the Company's results of operations and financial position.

Failure of information technology systems and breaches in the security of data upon which the Company relies could adversely affect the Company's future operating results.
Information technology system failures and breaches of data security could disrupt the Company's ability to function

Source: APPLE COMPUTER INC, 10-Q, May 05, 2006

seeking authorization to institute class actions on behalf of iPod nano purchasers in Quebec. A similar complaint, *Mund v. Apple Canada Inc. and Apple Computer, Inc.*, was filed in Ontario, Canada on January 9, 2006 seeking authorization to institute a class action on behalf of iPod nano purchasers in Canada.

Union Federale des Consummateurs – Que Choisir v. Apple Computer France S.A.R.L. and iTunes S.A.R.L.
Plaintiff, a consumer association in France, filed this complaint on February 9, 2005 alleging that the above–listed entities are violating consumer law by (1) omitting to mention that the iPod is allegedly not compatible with music from online music services other than the iTunes Music Store and that the music from the iTunes Music Store is only compatible with the iPod and (2) allegedly tying the sales of iPods to the iTunes Music Store and vice versa. Plaintiff seeks damages, injunctive relief and other relief. The first hearing on the case took place on May 24, 2005. The Company's response to the complaint was served on November 8, 2005.

Source: APPLE COMPUTER INC, 10-Q, February 03, 2006

Item 6. Exhibits

(a) Index to Exhibits

Exhibit Number	Exhibit Description	Incorporated by Reference Form	Filing Date/ Period End Date	Filed Herewith
3.1	Restated Articles of Incorporation, filed with the Secretary of State of the State of California on January 27, 1988.	S–3	7/27/88	
3.2	Amendment to Restated Articles of Incorporation, filed with the Secretary of State of the State of California on May 4, 2000.	10–Q	5/11/00	
3.3	By–Laws of the Company, as amended through June 7, 2004.	10–Q	6/26/04	
3.4	Certificate of Amendment to Restated Articles of Incorporation, as amended, filed with the Secretary of State of the State of California on February 25, 2005.	10–Q	3/26/05	
4.2	Indenture dated as of February 1, 1994, between the Company and Morgan Guaranty Trust Company of New York.	10–Q	4/01/94	
4.3	Supplemental Indenture dated as of February 1, 1994, among the Company, Morgan Guaranty Trust Company of New York, as resigning trustee, and Citibank, N.A., as successor trustee.	10–Q	4/01/94	
4.5	Form of the Company's 6 1/2% Notes due 2004.	10–Q	4/01/94	
4.8	Registration Rights Agreement, dated June 7, 1996 among the Company and Goldman, Sachs & Co. and Morgan Stanley & Co. Incorporated.	S–3	8/28/96	
4.9	Certificate of Determination of Preferences of Series A Non–Voting Convertible Preferred Stock of Apple Computer, Inc.	10–K	9/26/97	
10.A.3	Apple Computer, Inc. Savings and Investment Plan, as amended and restated effective as of October 1, 1990.	10–K	9/27/91	
10.A.3–1	Amendment of Apple Computer, Inc. Savings and Investment Plan dated March 1, 1992.	10–K	9/25/92	
10.A.3–2	Amendment No. 2 to the Apple Computer, Inc. Savings and Investment Plan.	10–Q	3/28/97	
10.A.5	1990 Stock Option Plan, as amended through November 5, 1997.	10–Q	12/26/97	
10.A.6	Apple Computer, Inc. Employee Stock Purchase Plan, as amended through April 21, 2005.	10–Q	3/26/05	
10.A.8	Form of Indemnification Agreement between the Registrant and each officer of the Registrant.	10–K	9/26/97	

Source: APPLE COMPUTER INC, 10-Q, February 03, 2006

10.A.43	NeXT Computer, Inc. 1990 Stock Option Plan, as amended.	S-8	3/21/97	
10.A.49	1997 Employee Stock Option Plan, as amended through October 19, 2001.	10-K	9/28/02	
10.A.50	1997 Director Stock Option Plan.	10-Q	3/27/98	
10.A.51	2003 Employee Stock Plan, as amended through November 9, 2005.	10-K	9/24/05	
10.A.52	Reimbursement Agreement dated as of May 25, 2001 by and between the Registrant and Steven P. Jobs.	10-Q	6/29/02	
10.A.53	Option Cancellation and Restricted Stock Award Agreement dated as of March 19, 2003 by and between The Registrant and Steven P. Jobs.	10-Q	6/28/03	
10.A.54	Form of Restricted Stock Unit Award Agreement.	10-Q	3/27/04	
10.A.54-1	Alternative Form of Restricted Stock Unit Award Agreement.	10-K	9/24/05	
10.A.55	Apple Computer, Inc. Performance Bonus Plan dated April 21, 2005.	10-Q	3/26/05	
10.A.56	Form of Election to Satisfy Tax Withholding with Stock.	8-K	8/15/05	
10.A.57	Form of Option Agreements.	10-K	9/24/05	
10.B.18*	Custom Sales Agreement effective October 21, 2002 between the Registrant and International Business Machines Corporation.	10-K	9/27/03	
10.B.19*	Purchase Agreement effective August 10, 2005 between the Registrant and Freescale Semiconductor, Inc.	10-K	9/24/05	
14.1	Code of Ethics of the Company.	10-K	9/27/03	
31.1	Rule13a-14(a) / 15d-14(a) Certification of Chief Executive Officer.			X
31.2	Rule13a-14(a) / 15d-14(a) Certification of Chief Financial Officer.			X
32.1	Section 1350 Certifications of Chief Executive Officer and Chief Financial Officer.			X

* Confidential treatment requested as to certain portion of this exhibit.

Source: APPLE COMPUTER INC, 10-Q, February 03, 2006

SIGNATURE

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.

February 2, 2006

APPLE COMPUTER, INC.

By: /s/ Peter Oppenheimer
Peter Oppenheimer
Senior Vice President and
Chief Financial Officer

Source: APPLE COMPUTER INC, 10-Q, February 03, 2006

Exhibit 31.1

CERTIFICATIONS

I, Steven P. Jobs, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Apple Computer, 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(s) 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 (the registrant's fourth fiscal quarter in the case of an annual report) 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(s) 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 (or persons performing the equivalent functions):

   (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.

Date: February 2, 2006

By: /s/ Steven P. Jobs
Steven P. Jobs
Chief Executive Officer

Source: APPLE COMPUTER INC, 10-Q, February 03, 2006

Exhibit 31.2

CERTIFICATIONS

I, Peter Oppenheimer, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Apple Computer, 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(s) 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 (the registrant's fourth fiscal quarter in the case of an annual report) 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(s) 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 registrant's board of directors (or persons performing the equivalent functions):

   (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.

Date: February 2, 2006

By: /s/ Peter Oppenheimer
Peter Oppenheimer
Senior Vice President and
Chief Financial Officer

Source: APPLE COMPUTER INC, 10-Q, February 03, 2006

Exhibit 32.1

CERTIFICATION OF CHIEF EXECUTIVE OFFICER AND CHIEF FINANCIAL OFFICER
PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

I, Steven P. Jobs, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that the Quarterly Report of Apple Computer, Inc. on Form 10-Q for the period ended December 31, 2005 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that information contained in such Form 10-Q fairly presents in all material respects the financial condition and results of operations of Apple Computer, Inc.

By: /s/ Steven P. Jobs
Steven P. Jobs
Chief Executive Officer

I, Peter Oppenheimer, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that the Quarterly Report of Apple Computer, Inc. on Form 10-Q for the period ended December 31, 2005 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that information contained in such Form 10-Q fairly presents in all material respects the financial condition and results of operations of Apple Computer, Inc.

By: /s/ Peter Oppenheimer
Peter Oppenheimer
Senior Vice President and Chief Financial Officer

Created by 10KWizard www.10KWizard.com

Source: APPLE COMPUTER INC, 10-Q, February 03, 2006

EXHIBIT CO 0733

Apple Computer, Inc.
Q4 2006 Unaudited Summary Data

	Q3'06 Actual		Q4'05 Actual		Q4'06 Actual		Sequential Change		Year/Year Change	
Operating Segments	CPU Units K	Rev M$	CPU Units K	Rev M$	CPU Units K	Rev M$	CPU Units	Rev.	CPU Units	Rev.
Americas	642	$2,188	636	$1,771	781	$2,297	22%	5%	23%	30%
Europe	301	899	259	779	342	987	14%	10%	32%	27%
Japan	79	258	71	224	62	286	- 22%	11%	- 13%	28%
Retail	216	715	202	663	323	936	50%	31%	60%	41%
Other Segments (1)	89	310	68	241	102	331	15%	7%	50%	37%
Total Operating Segments	1,327	$4,370	1,236	$3,678	1,610	$4,837	21%	11%	30%	32%

							Sequential Change		Year/Year Change	
	Units K	Rev M$	Units K	Rev M$	Units K	Rev M$	Units	Rev.	Units	Rev.
Product Summary										
Desktops (2)	529	$705	602	$787	624	$869	18%	23%	4%	10%
Portables (3)	798	1,161	634	824	986	1,344	24%	16%	56%	63%
Subtotal CPUs	1,327	1,866	1,236	1,611	1,610	2,213	21%	19%	30%	37%
iPod	8,111	1,497	6,451	1,212	8,729	1,559	8%	4%	35%	29%
Other Music Related Products and Services (4)	NM	457	NM	265	NM	452	NM	- 1%	NM	71%
Peripherals and Other Hardware	NM	236	NM	296	NM	297	NM	26%	NM	0%
Software, Service and Other Sales	NM	314	NM	294	NM	316	NM	1%	NM	7%
Total Apple		$4,370		$3,678		$4,837		11%		32%

(1) Other Segments include Asia Pacific and FileMaker.
(2) Includes iMac, eMac, Mac mini, Mac Pro, PowerMac, and Xserve product lines.
(3) Includes MacBook, iBook, MacBook Pro and PowerBook product lines.
(4) Consists of iTunes Music Store sales, iPod services, and Apple-branded and third-party iPod accessories.

NM: Not Meaningful

EXHIBIT CO 0734

PRELIMINARY UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS

(In millions, except share amounts)

ASSETS:

	September 30, 2006	September 24, 2005
Current assets:		
Cash and cash equivalents	$6,392	$3,491
Short-term investments	3,718	4,770
Accounts receivable, less allowances of $52 and $46, respectively	1,252	895
Inventories	270	165
Other current assets	2,877	979
Total current assets	14,509	10,300
Property, plant, and equipment, net	1,281	817
Other assets	1,454	434
Total assets	$17,244	$11,551

LIABILITIES AND SHAREHOLDERS' EQUITY:

Current liabilities:		
Accounts payable	$3,390	$1,779
Accrued expenses	3,066	1,705
Total current liabilities	6,456	3,484
Non-current liabilities	750	601
Total liabilities	7,206	4,085
Commitments and contingencies		
Total shareholders' equity	10,038	7,466
Total liabilities and shareholders' equity	$17,244	$11,551

The information contained in these preliminary unaudited condensed consolidated financial statements may be subject to significant adjustment. For additional information, please refer to the accompanying press release dated October 18, 2006.

PRELIMINARY UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(In millions, except share and per share amounts)

	Three Months Ended		Twelve Months Ended	
	September 30, 2006	September 24, 2005	September 30, 2006	September 24, 2005
Net sales	$4,837	$3,678	$19,315	$13,931
Cost of sales (1)	3,425	2,643	13,717	9,888
Gross margin	1,412	1,035	5,598	4,043
Operating expenses:				
Research and development (1)	179	147	712	534
Selling, general, and administrative (1)	624	470	2,432	1,859
Total operating expenses	803	617	3,144	2,393
Operating income	609	418	2,454	1,650
Other income and expense	113	60	365	165
Income before provision for income taxes	722	478	2,819	1,815
Provision for income taxes	176	48	826	480
Net income	$ 546	$ 430	$ 1,993	$ 1,335
Earnings per common share:				
Basic	$ 0.64	$ 0.52	$ 2.36	$ 1.65
Diluted	$ 0.62	$ 0.50	$ 2.27	$ 1.56
Shares used in computing earnings per share (in thousands):				
Basic	854,187	821,420	844,058	808,439
Diluted	878,757	866,404	877,526	856,780
(1) Stock-based compensation expense was allocated as follows:				
Cost of sales	$ 5	$ 1	$21	$ 2
Research and development	$13	$ 2	$53	$ 6
Selling, general, and administrative	$21	$ 8	$88	$34

The information contained in these preliminary unaudited condensed consolidated financial statements may be subject to significant adjustment. For additional information, please refer to the accompanying press release dated October 18, 2006.

EXHIBIT CO 0735

Apple Computer, Inc.
Q3 2006 Unaudited Summary Data

	Q2 2006 Actual		Q3 2005 Actual		Q3 2006 Actual		Sequential Change		Year/Year Change	
Operating Segments	CPU Units K	Rev $M	CPU Units K	Rev $M	CPU Units K	Rev $M	Units	Revenue	Units	Revenue
Americas	494	$2,122	595	$1,739	642	$2,188	30%	3%	8%	26%
Europe	316	966	283	742	301	899	- 5%	- 7%	6%	21%
Japan	82	309	76	227	79	258	- 4%	- 17%	4%	14%
Retail	154	636	144	555	216	715	40%	12%	50%	29%
Other Segments (1)	66	326	84	257	89	310	35%	- 5%	6%	21%
Total Operating Segments	1,112	$4,359	1,182	$3,520	1,327	$4,370	19%	0%	12%	24%

							Sequential Change		Year/Year Change	
	Units K	Rev $M	Units K	Rev $M	Units K	Rev $M	Units	Revenue	Units	Revenue
Product Summary										
Desktops (2)	614	$833	687	$845	529	$705	- 14%	- 15%	- 23%	- 17%
Portables (3)	498	739	495	720	798	1,161	60%	57%	61%	61%
Subtotal CPUs	1,112	1,572	1,182	1,565	1,327	1,866	19%	19%	12%	19%
iPod	8,526	1,714	6,155	1,103	8,111	1,497	- 5%	- 13%	32%	36%
Other Music Related Products and Services (4)	NM	485	NM	241	NM	457	NM	- 6%	NM	90%
Peripherals and Other Hardware	NM	264	NM	266	NM	236	NM	- 11%	NM	- 11%
Software, Service and Other Sales	NM	324	NM	345	NM	314	NM	- 3%	NM	- 9%
Total Apple		$4,359		$3,520		$4,370		0%		24%

(1) Other Segments include Asia Pacific and FileMaker.
(2) Includes iMac, eMac, Mac mini, PowerMac and Xserve product lines.
(3) Includes MacBook, iBook, MacBook Pro and PowerBook product lines.
(4) Consists of iTunes Music Store sales, iPod services, and Apple-branded and third-party iPod accessories.

NM: Not Meaningful

EXHIBIT CO 0736

UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS

(In millions, except share amounts)

ASSETS:

	July 1, 2006	September 24, 2005
Current assets:		
Cash and cash equivalents	$8,013	$3,491
Short-term investments	1,163	4,770
Accounts receivable, less allowances of $51 and $46, respectively	1,089	895
Inventories	213	165
Deferred tax assets	491	331
Other current assets	1,522	648
Total current assets	12,491	10,300
Property, plant, and equipment, net	1,197	817
Goodwill	38	69
Acquired intangible assets	37	27
Other assets	1,386	338
Total assets	$15,149	$11,551

LIABILITIES AND SHAREHOLDERS' EQUITY:

Current liabilities:		
Accounts payable	$2,513	$1,779
Accrued expenses	2,507	1,705
Total current liabilities	5,020	3,484
Non-current liabilities	761	601
Total liabilities	5,781	4,085
Commitments and contingencies		
Shareholders' equity:		
Common stock, no par value; 1,800,000,000 shares authorized; 852,987,629 and 835,019,364 shares issued and outstanding, respectively	4,207	3,521
Deferred stock compensation	-	(60)
Retained earnings	5,145	4,005
Accumulated other comprehensive income	16	-
Total shareholders' equity	9,368	7,466
Total liabilities and shareholders' equity	$15,149	$11,551

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(In millions, except share and per share amounts)

	THREE MONTHS ENDED		NINE MONTHS ENDED	
	July 1, 2006	June 25, 2005	July 1, 2006	June 25, 2005
Net sales	$4,370	$3,520	$14,478	$10,253
Cost of sales (1)	3,045	2,476	10,292	7,245
Gross margin	1,325	1,044	4,186	3,008
Operating expenses:				
Research and development (1)	175	145	533	387
Selling, general, and administrative (1)	584	472	1,808	1,389
Total operating expenses	759	617	2,341	1,776
Operating income	566	427	1,845	1,232
Other income and expense	95	46	252	105
Income before provision for income taxes	661	473	2,097	1,337
Provision for income taxes	189	153	650	432
Net income	$ 472	$ 320	$ 1,447	$ 905
Earnings per common share:				
Basic	$ 0.55	$ 0.39	$1.72	$ 1.13
Diluted	$ 0.54	$ 0.37	$1.65	$ 1.06
Shares used in computing earnings per share (in thousands):				
Basic	851,375	815,092	840,759	804,098
Diluted	876,368	860,688	876,971	853,105

(1) Stock-based compensation expense was allocated as follows:

Cost of sales	$ 6	$ -	$16	$ 1
Research and development	$12	$ 2	$40	$ 4
Selling, general, and administrative	$19	$ 9	$67	$26

UNAUDITED RECONCILIATION OF NON-GAAP TO GAAP RESULTS OF OPERATIONS

(In millions, except share and per share amounts)

	Three Months Ended July 1, 2006				Three Months Ended June 25, 2005			
	As Reported	Non-GAAP Adjustments	(a)	Non-GAAP	As Reported	Non-GAAP Adjustments	(a)	Non-GAAP
Gross Margin	$1,325	$6	(b)	$1,331	$1,044	$ -		$1,044
Gross Margin Percentage	30.3%	0.1%	(b)	30.4%	29.7%	-		29.7%
Operating Income	$566	$37	(b)	$603	$427	$11	(c)	$438
Operating Margin Percentage	13.0%	0.8%	(b)	13.8%	12.1%	0.3%	(c)	12.4%
Provision for Income Taxes	$189	$10	(d)	$199	$153	$1	(d)	$154
Net Income	$472	$27		$499	$320	$10		$330
Earnings per common share:								
Basic	$0.55			$0.59	$0.39			$0.40
Diluted	$0.54			$0.57	$0.37			$0.38
Shares used in computing earnings per share (in thousands):								
Basic	851,375			851,375	815,092			815,092
Diluted	876,368			876,368	860,688			860,688

(a) These adjustments reconcile the Company's GAAP results of operations to its non-GAAP results of operations. The Company believes that presentation of results excluding non-cash stock-based compensation provides meaningful supplemental information to both management and investors that is indicative of the Company's core operating results and facilitates comparison of operating results across reporting periods. The Company uses these non-GAAP measures when evaluating its financial results as well as for internal planning and forecasting purposes. These non-GAAP measures should not be viewed as a substitute for the Company's GAAP results. The Company adopted the fair-value recognition provisions of SFAS No. 123 revised (123R) to expense stock-based compensation in its fiscal quarter ended December 31, 2005. Prior to the adoption of SFAS No. 123R, the Company accounted for employee stock-based compensation using the intrinsic value method prescribed by APB No. 25.

(b) These adjustments reflect the non-cash stock-based compensation expense as measured under SFAS No. 123R related to unvested stock awards, including stock options, restricted stock units, and employee stock purchase plan shares. The fair-value calculated expense as determined on the awards' grant date is recognized as the requisite service is rendered.

(c) These adjustments reflect the non-cash compensation expense as measured under APB No. 25 related primarily to restricted stock awarded to the Company's CEO in fiscal 2003 and restricted stock units awarded to selected members of the Company's senior management team in fiscal 2004 and 2005. Note that neither the Company's GAAP nor non-GAAP results of operations in fiscal year 2005 included the accounting impact had the Company chosen to apply the fair-value recognition provisions of SFAS No. 123R.

(d) Amount reflects the expected tax impact on the above noted non-GAAP adjustments.

UNAUDITED RECONCILIATION OF NON-GAAP TO GAAP RESULTS OF OPERATIONS

(In millions, except share and per share amounts)

	Nine Months Ended July 1, 2006				Nine Months Ended June 25, 2005			
	As Reported	Non-GAAP Adjustments	(a)	Non-GAAP	As Reported	Non-GAAP Adjustments	(a)	Non-GAAP
Gross Margin	$4,186	$16	(b)	$4,202	$3,008	$ 1	(c)	$3,009
Gross Margin Percentage	28.9%	0.1%	(b)	29.0%	29.3%	-	(c)	29.3%
Operating Income	$1,845	$123	(b)	$1,968	$1,232	$31	(c)	$1,263
Operating Margin Percentage	12.7%	0.9%	(b)	13.6%	12.0%	0.3%	(c)	12.3%
Provision for income taxes	$650	$36	(d)	$686	$432	$3	(d)	$435
Net Income	$1,447	$87		$1,534	$905	$28		$933
Earnings per common share:								
Basic	$1.72			$1.82	$1.13			$1.16
Diluted	$1.65			$1.75	$1.06			$1.09
Shares used in computing earnings per share (in thousands):								
Basic	840,759			840,759	804,098			804,098
Diluted	876,971			876,971	853,105			853,105

(a) These adjustments reconcile the Company's GAAP results of operations to its non-GAAP results of operations. The Company believes that presentation of results excluding non-cash stock-based compensation provides meaningful supplemental information to both management and investors that is indicative of the Company's core operating results and facilitates comparison of operating results across reporting periods. The Company uses these non-GAAP measures when evaluating its financial results as well as for internal planning and forecasting purposes. These non-GAAP measures should not be viewed as a substitute for the Company's GAAP results. The Company adopted the fair-value recognition provisions of SFAS No. 123 revised (123R) to expense stock-based compensation in its fiscal quarter ended December 31, 2005. Prior to the adoption of SFAS No. 123R, the Company accounted for employee stock-based compensation using the intrinsic value method prescribed by APB No. 25.

(b) These adjustments reflect the non-cash stock-based compensation expense as measured under SFAS No. 123R related to unvested stock awards, including stock options, restricted stock, restricted stock units, and employee stock purchase plan shares. The fair-value calculated expense as determined on the awards' grant date is recognized as the requisite service is rendered.

(c) These adjustments reflect the non-cash compensation expense as measured under APB No. 25 related primarily to restricted stock awarded to the Company's CEO in fiscal 2003 and restricted stock units awarded to selected members of the Company's senior management team in fiscal 2004 and 2005. Note that neither the Company's GAAP nor non-GAAP results of operations in fiscal year 2005 included the accounting impact had the Company chosen to apply the fair-value recognition provisions of SFAS No. 123R.

(d) Amount reflects the expected tax impact on the above noted non-GAAP adjustments.

UNAUDITED RECONCILIATION OF NON-GAAP TO GAAP FINANCIAL GUIDANCE SUMMARY

(In millions, except per share amounts)

The financial guidance provided below is an estimate based on information available as of July 19, 2006. The Company's future performance and financial results are subject to risks and uncertainties, and actual results could differ materially from the guidance set forth below. Some of the factors that could affect the Company's financial results are stated above in this press release. More information on potential factors that could affect the Company's financial results is included from time to time in the Company's public reports filed with the SEC, including the Company's Form 10-K for the fiscal year ended September 24, 2005, the Company's Form 10-Q for the quarters ended December 31, 2005 and April 1, 2006, and the Company's Form 10-Q for the quarter ended July 1, 2006 to be filed with the SEC. The Company assumes no obligation to update any forward-looking statements or information, which speak as of their respective dates.

	Q4 2006 Financial Guidance Summary			
	GAAP	Non-GAAP Adjustments	*(a)*	Non-GAAP
Gross margin percentage	28.4%	0.1%	*(b)*	28.5%
Operating expenses	$785	$34	*(b)*	$751
Diluted earnings per common share	$0.46 - $0.48	$0.03	*(c)*	$0.49 - $0.51

(a) These adjustments reconcile the Company's GAAP to its non-GAAP financial guidance for the fourth quarter of fiscal 2006. The Company believes that excluding non-cash stock-based compensation provides meaningful supplemental information to both management and investors that is indicative of the Company's core operating results and facilitates comparison of operating results across reporting periods. The Company uses these non-GAAP measures when evaluating its financial results as well as for internal planning and forecasting purposes. These non-GAAP measures should not be viewed as a substitute for the Company's GAAP results.

(b) Reflects the expected non-cash compensation expense attributable to stock-based compensation awards including stock options, restricted stock units, and employee stock purchase plan shares. This amount reflects the total estimated expense from the application of SFAS No. 123R, which the Company adopted in the first quarter of fiscal 2006.

(c) This adjustment represents the expected net of tax impact on earnings per share from the non-GAAP adjustments related to stock-based compensation expense.

EXHIBIT CO 0737

3rd Quarter 2006 Investor Update

October 26, 2006

Sprint POWER UP™

Together with NEXTEL

Cautionary Statement

Sprint
Together with NEXTEL

This presentation includes "forward-looking statements" within the meaning of the securities laws. The statements in this presentation regarding the business outlook and expected performance, as well as other statements that are not historical facts, are forward-looking statements. The words "estimate," "project," "forecast," "intend," "expect," "believe," "target," "providing guidance" and similar expressions are intended to identify forward-looking statements. Forward-looking statements are estimates and projections reflecting management's judgment based on currently available information and involve a number of risks and uncertainties that could cause actual results to differ materially from those suggested by the forward-looking statements. With respect to these forward-looking statements, management has made assumptions regarding, among other things, customer and network usage, customer growth and retention, pricing, operating costs, the timing of various events and the economic environment. Future performance cannot be ensured. Actual results may differ materially from those in the forward-looking statements. Some factors that could cause actual results to differ include:

- the effects of vigorous competition, including the impact of competition on the price we are able to charge customers for the services we provide and on Sprint Nextel's ability to attract new customers and retain existing customers; the overall demand for Sprint Nextel's service offerings, including the impact of decisions of new subscribers between Sprint Nextel's post-paid and prepaid services offerings and between Sprint Nextel's two network platforms; and the impact of new, emerging and competing technologies on Sprint Nextel's business;
- the impact of overall wireless market penetration on Sprint Nextel's ability to attract and retain customers with good credit standing and the intensified competition among wireless carriers for those customers;
- the uncertainties related to the benefits of the Sprint-Nextel merger, including anticipated synergies and cost savings and the timing thereof;
- the potential impact of difficulties we may encounter in connection with the integration of the pre-merger Sprint and Nextel businesses, and the integration of the businesses and assets of certain of the third party affiliates, or PCS Affiliates, that provide wireless personal communications services, or PCS, under the Sprint® brand that we have acquired, and Nextel Partners, Inc., including the risk that these difficulties could prevent or delay Sprint Nextel's realization of the cost savings and other benefits we expect to achieve as a result of these integration efforts and the risk that Sprint Nextel will be unable to continue to retain key employees;
- the uncertainties related to the implementation of Sprint Nextel's business strategies and Sprint Nextel's investments in networks, systems, and other businesses, including investments required in connection with Sprint Nextel's planned deployment of a next generation broadband wireless network;
- the costs and business risks associated with providing new services and entering new geographic markets, including with respect to Sprint Nextel's development of new services expected to be provided using the next generation broadband wireless network that we plan to deploy;
- the impact of potential adverse changes in the ratings afforded Sprint Nextel's debt securities by ratings agencies;
- the ability of Wireless to continue to grow and improve profitability;
- the ability of Long Distance to achieve expected revenues;
- the effects of mergers and consolidations in the communications industry and unexpected announcements or developments from others in the communications industry;
- unexpected results of litigation filed against Sprint Nextel;
- the inability of third parties to perform to Sprint Nextel's requirements under agreements related to Sprint Nextel's business operations;
- no significant adverse change in Motorola, Inc.'s ability or willingness to provide handsets and related equipment and software applications or to develop new technologies or features for the iDEN network;
- the impact of adverse network performance, including, but not limited to, any performance issues resulting from reduced network capacity and other adverse impacts resulting from the reconfiguration of the 800 Megahertz band used to operate the iDEN network, as contemplated by the Federal Communications Commission's, or FCC's, Report and Order, released in August 2004 and supplemented thereafter;
- the costs of compliance with regulatory mandates, particularly requirements related to the FCC's Report and Order, deployment of enhanced 911, or E911, services on the iDEN network and privacy-related matters;
- equipment failure, natural disasters, terrorist acts, or other breaches of network or information technology security;
- one or more of the markets in which Sprint Nextel competes being impacted by changes in political or other factors such as monetary policy, legal and regulatory changes or other external factors over which Sprint Nextel has no control; and
- other risks referenced from time to time in Sprint Nextel's filings with the Securities and Exchange Commission, including its Form 10-K for the year ended December 31, 2005, as amended, in Part I, Item 1A, "Risk Factors."

Sprint Nextel believes these forward-looking statements are reasonable; however, you should not place undue reliance on forward-looking statements, which are based on current expectations and speak only as of the date of this presentation. Sprint Nextel is not obligated to publicly release any revisions to forward-looking statements to reflect events after the date of this release.

Normalizing EPS

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	Q3-2006		Q3-2005	
	Net Income	EPS	Net Income	EPS
Reported - Continuing Operations	$247	$0.08	$156	$0.05
Merger costs & other special items	$51	$0.02	$237	$0.08
Amortization	$650	$0.22	$504	$0.17
Adjusted	$948	$0.32	$897	$0.30

Net income dollars are in millions. Merger costs and other special items include restructuring, asset impairment costs, discount/premium on early retirement of debt, favorable tax settlement, and net gains on investments. Net Income and earnings per share (EPS) figures are shown net of taxes. Q3, 2005 numbers are pro forma for acquisition of Nextel Communications. Adjusted figures in green row are shown before amortization.

Gary Forsee

Chief Executive Officer

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Sprint Nextel Mission

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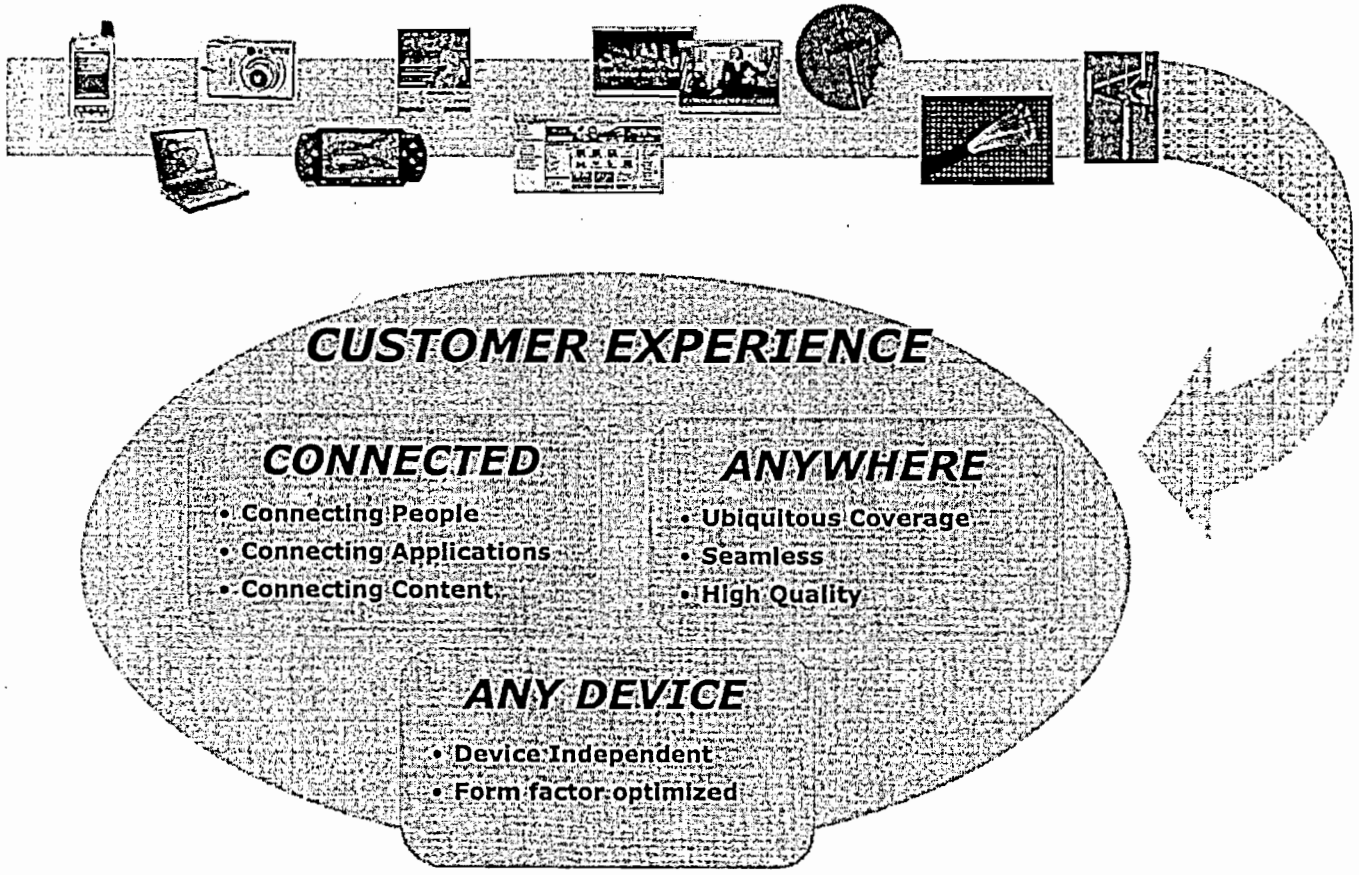
"Best products and services on the most powerful network"



Key 3Q Actions

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Follow Through on 2Q Commitments

- ☑ Network investments
- ☑ Evolving the brand
- ☑ Credit tightening
- ☑ Addressing ARPU
- ☑ Energized handset portfolio including hybrid phone
- ☑ Strengthening distribution
- ☑ Restructured sales, service & distribution

Additional Achievements

- ☑ 7 pilot markets in Cable JV
- ☑ Announced 4G technology
- ☑ Launched consumer advertising
- ☑ Improved margins by scaling opex
- ☑ Share repurchases

3Q Consolidated Highlights

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	3Q06	Proforma 3Q05	Δ	2Q06	Δ
Net Operating Revenues	$10.5B	$9.7B	8%	$10.0B	5%
Adjusted Op Income	$824M	$874M	-6%	$865M	-5%
Adjusted OIBDA	$3.36B	$2.95B	14%	$3.22B	5%
Adjusted OIBDA Margin	34.8%	33.3%	+150 bps	34.7%	+10 bps
Adjusted OIBDA less Capex	$1.52B	$1.55B	-2%	$1.86B	-18%
Adjusted EPS before Amort	$0.32	$0.30	7%	$0.32	-

- Purchased 91M common shares for approx. $1.5B in 3Q06
- 51.9M subscribers including acquisitions

Churn Improvement Required

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3Q06 Results

- Post-paid churn of 2.4%
  - Roughly 55% voluntary / 45% involuntary
- Higher sequential churn
  - Seasonally higher CDMA involuntary churn
  - Higher core iDEN voluntary churn
  - High NXTP churn

Actions

- Policy changes that will improve involuntary churn
  - Overall credit tightening
  - Specific credit tightening in iDEN capacity constrained markets
- Significant investment that will improve voluntary churn
  - Brand, network & handset program including new handset line-up

Net Adds Results

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CDMA

- Gross adds stable
- Strong growth in aircards
- Prime gross adds highest in 7 quarters

iDEN

- Gross adds down sequentially and down significantly y-o-y
- Declining subscribers driven by credit tightening & higher churn
- Boost Mobile net adds lower due to managing growth & competition

Post-Paid Net Adds		Pre-Paid Net Adds		MVNO Net Adds		Affiliate Net Adds		Total 3Q06 Net Adds
-188K	+	**216K**	+	**177K**	+	**28K**	=	**233K**

New Branding and Marketing Campaign

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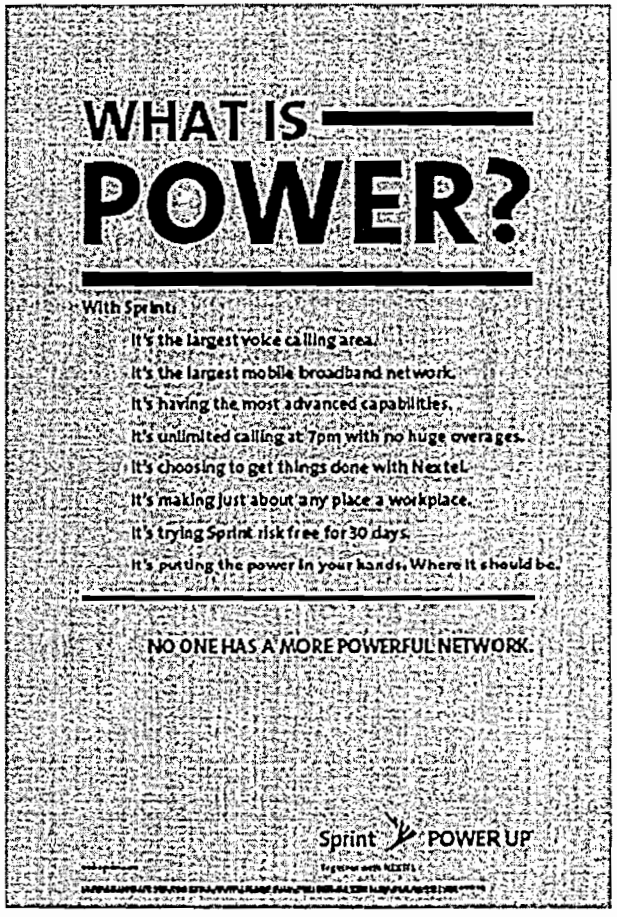
- "Power Up" on the nation's most powerful network
- Positions network capabilities, price/value and innovation
- Aggressively highlighting our superior wireless data network
- NFL, NASCAR advertising with Power Vision applications
- New consumer advertising launch in October



Clear Wireless Data Leadership

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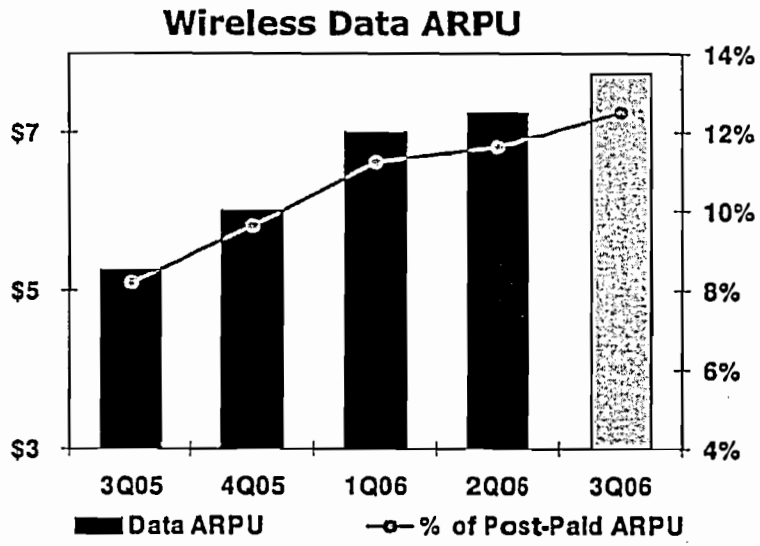

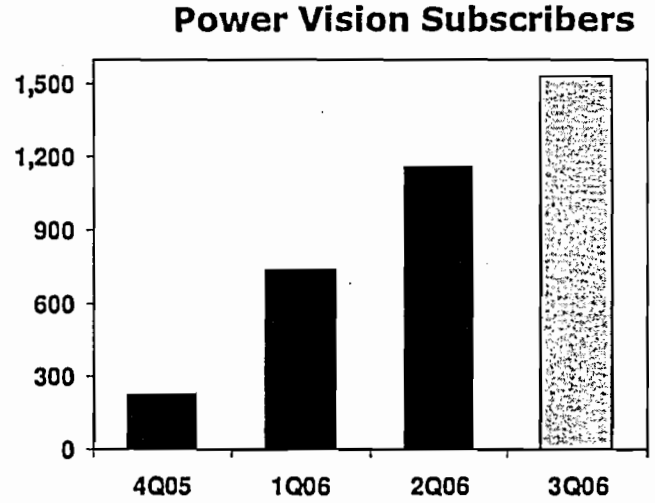

- Nation's largest wireless broadband network
  - Now 168M covered pops, expanding to 200M by YE06
- Data ARPU of $7.75, CDMA data ARPU over $10
- Nearly $4B annualized revenue
- Hybrid phone allows richer data offerings

Strong Cable Relationship

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Wireline

- 12 separate cable agreements
- Annualized revenues of over $275 million
- Over 1.3 million cable telephony subscribers, increase of 116% y-o-y
- Strong demand for cable voice service driving growth rates

Cable Joint Venture

- 7 pilot markets in advance of broader market launch in '07
- Product is compelling and leverages cable content, VOIP and HSD integration
- Significant systems capability developed and integrated

Update on Boost Mobile / MVNOs

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- Service revenues increased 82% y-o-y
- Over 3.8M subscribers, increase of 93% y-o-y
- Strong OIBDA margin
- Market opportunity attracting competition

MVNOs

- Annualized revenue exceeds $650M
- Over 5.5M subscribers, increase of 20% y-o-y
- Improved sequential gross & net add performance across nearly all MVNOs

Technology Roadmap On Track

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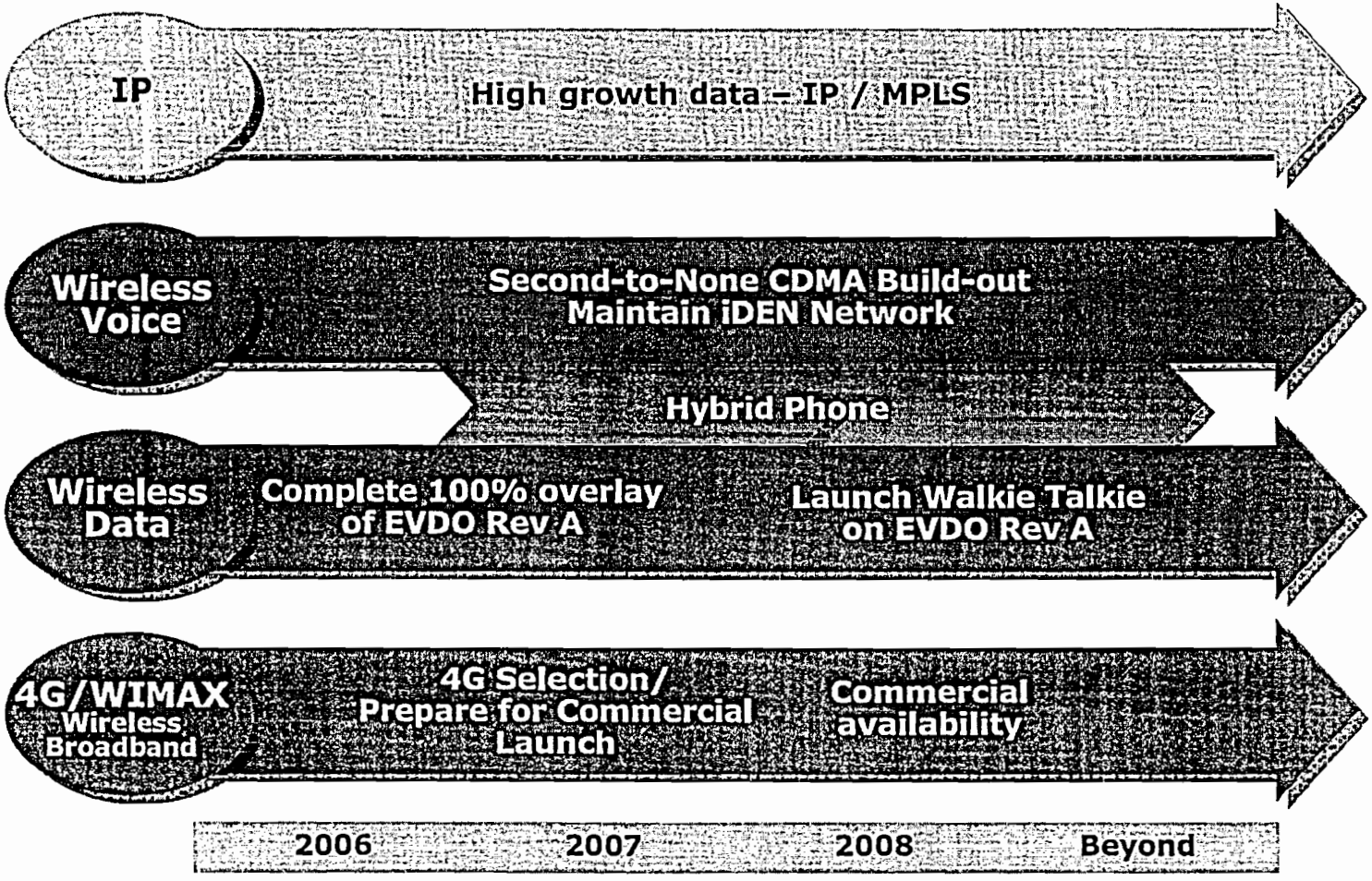

Update on iDEN Network

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- Making significant investments
  - Improved performance with new tools and tuning
  - $2B capital spending in 2006
  - 1,600 new quality & coverage cell sites in 2006
  - Commitment to industry's best walkie-talkie service
- Begin utilizing the power of the two networks with hybrid phone
- Re-banding progress
  - Fully committed to rebanding
  - Phase 1 milestones on-time and on-budget
  - Increased complexity with Phase 2

Focus Areas into 2007

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Growing the Business

- ***Reduce churn***
- Capitalize on wireless data leadership
- Leverage new branding and marketing campaign
- Continue to invest in distribution
- Continue to improve the customer mix

Improving Operating Performance

- Invest in the networks
- Simplify business to capture cost savings
- Continue to execute and deliver on merger synergies
- Customer service initiatives
- Execute the technology plan

Paul Saleh

Chief Financial Officer

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Financial Highlights

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Wireless ($ millions)	3Q-2006	Sequential Change	Annual Change
Service Revenue	$8,229	6%	14%
Adj. OIBDA	$3,159	8%	20%
Adj. OIBDA Margin	38.4%	+ 80 bps	+190 bps
Long Distance			
Revenue	$1,626	-1%	-6%
Adj. OIBDA	$206	-25%	-27%
Adj. OIBDA Margin	12.7%	- 410 bps	-360 bps
Consolidated			
Net Operating Revenue	$10,496	5%	8%
Adjusted OIBDA	$3,364	5%	14%
Adjusted OIBDA Margin	34.8%	+10 bps	+150 bps

Note wireless OIBDA margins are calculated as adjusted OIBDA/ (Wireless service revenues + wholesale, affiliates and other revenues). Q3, 2006 figures are compared to Q3, 2005 pro forma figures.

Wireless ARPU Trends

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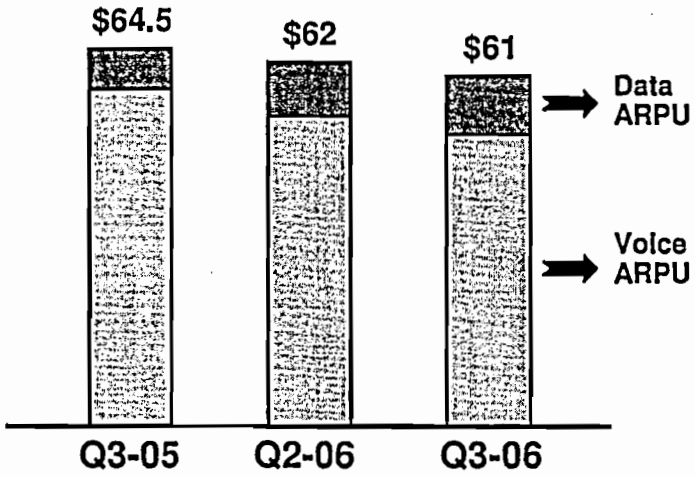
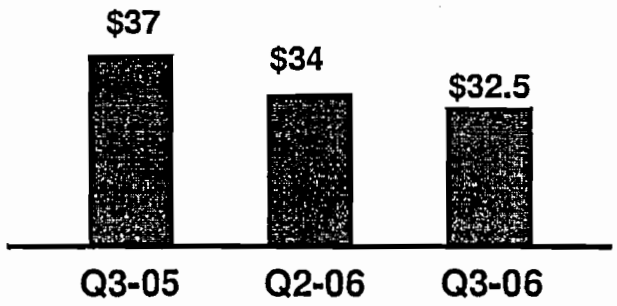
Postpaid



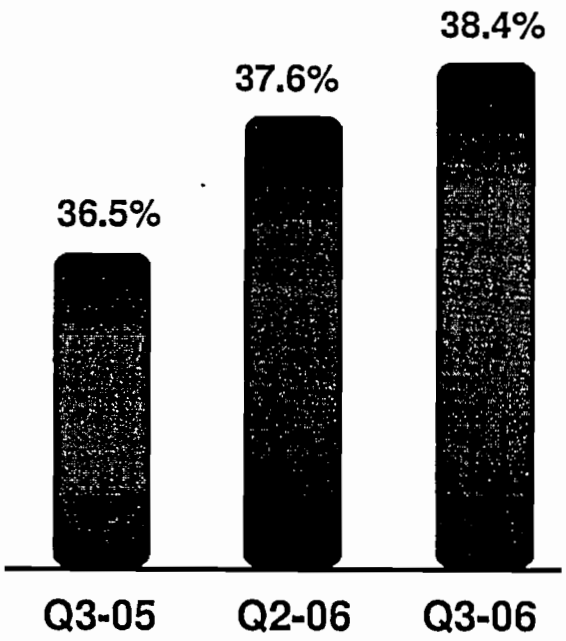
- **Sequential decline of 1%**
  - **Voice ARPU declines partially offset by data ARPU growth**
  - **Data ARPU was approx $7.75, up 45% y-o-y**
- **Y-o-Y ARPU decline was ~4% after adjusting for impact of acquisitions**

Prepaid



- **Sequential decline of 3%**
  - **Declining voice usage**
  - **Impact of competitive pressures**

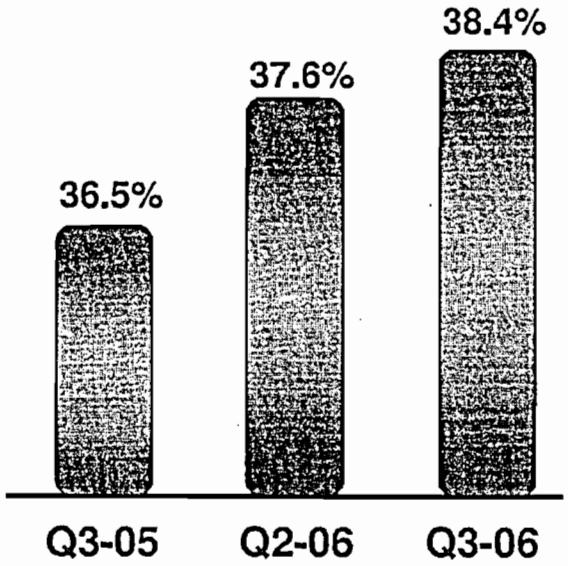
Wireless Adjusted OIBDA Margins
3Q-2006



- Contributions from acquisitions offset by lower ARPU, higher churn and bad debt
- Merger synergies accelerating
  - ✓ Savings from renegotiated contracts
  - ✓ Rationalization of retail stores
  - ✓ Reduction in commercial real estate
- Continued focus on scaling costs

Note: Adjusted OIBDA margin is defined as Adjusted OIBDA /(wireless service revenues plus wholesale affiliate and other revenues)

Wireless Adjusted OIBDA Margins



- Merger synergies accelerating
- Continued focus on scaling costs
- Nextel Partners contribution offset by impact of lower ARPU, higher churn and bad debt

Investing for Long-term Value

- More aggressive handset pricing
- Building coverage & quality sites
- Accelerating EV-DO build
- Advertising & brand positioning
- Strengthening 3rd party distribution
- Improving customer care

Strong Free Cash Flow Generation
Q3, 2006

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(Millions)	
Adjusted OIBDA	**$3,364**
Special items	**($157)**
Other operating activity, net	**($303)**
Capital expenditures	**($1,885)**
Dividends paid	**($74)**
Other investing activities, net	**($176)**
Free Cash Flow	**$769**

Note: Other operating activities, net includes the change in working capital, change in deferred income taxes, miscellaneous operating activities and non-operating items in net income (loss).

Strong Financial Position

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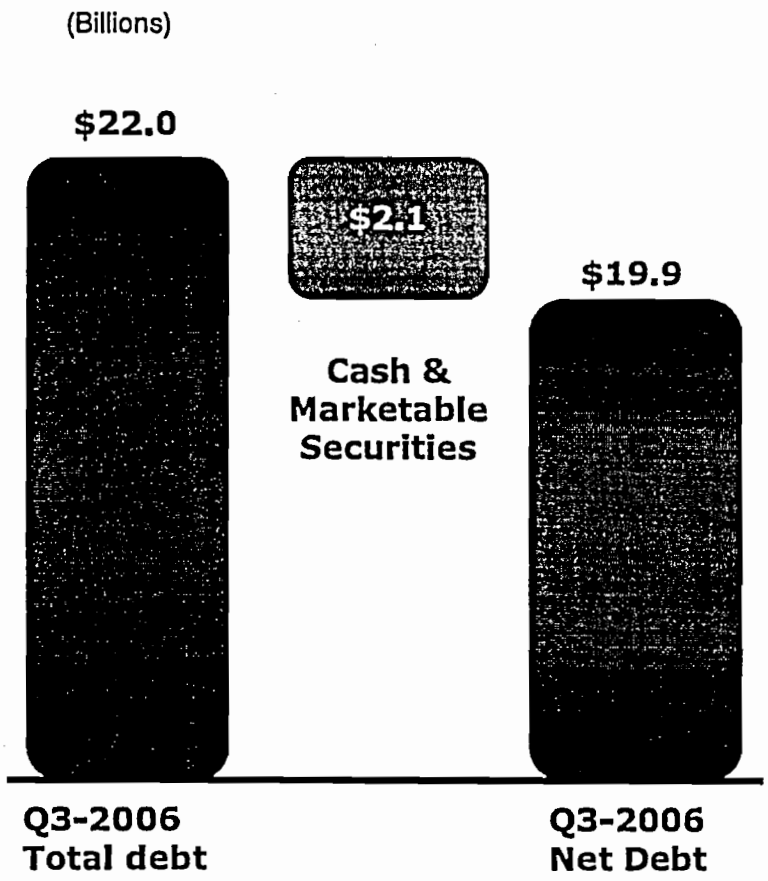

- $1.5B share buyback
- $1.8B debt retirements
- $1.3B acquisition of UbiquiTel
- Net Debt/Annual Adj. OIBDA of 1.5X
- Average cost of debt ~7%

Unchanged 2006 Guidance

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- Consolidated operating revenues of ***$41 to $41.5B***
- Adjusted OIBDA of ***$12.6 to $12.9B***
- Capital expenditures of ***$7.0 to $7.1B*** including re-banding

Conclusion

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- ✓ Realizing significant merger synergies
- ✓ Generating solid free cash flow from operations
- ✓ Maintaining a strong balance sheet and financial flexibility
- ✓ Enhancing shareholder returns through share buyback program
- ✓ Investing for long term value
- ✓ Focusing on operational execution

Questions & Answers

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Non-GAAP Measures and Reconciliations

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Sprint Nextel provides financial measures generated using generally accepted accounting principles (GAAP) and using adjustments to GAAP (non-GAAP). The non-GAAP financial measures reflect industry conventions, or standard measures of liquidity, profitability or performance commonly used by the investment community for comparability purposes. These non-GAAP measures are not measurements under accounting principles generally accepted in the United States. These measurements should be considered in addition to, but not as a substitute for, the information contained in our financial statements prepared in accordance with GAAP. We have defined below each of the non-GAAP measures we use, but these measures may not be synonymous to similar measurement terms used by other companies. Sprint Nextel provides reconciliations of these non-GAAP measures in its financial reporting. Because Sprint Nextel does not predict special items that might occur in the future, and our forecasts are developed at a level of detail different than that used to prepare GAAP-based financial measures, Sprint Nextel does not provide reconciliations to GAAP of its forward-looking financial measures.

The measures used in this release include the following:

Adjusted Earnings per Share (EPS) is defined as income from continuing operations, before special items, net of tax and the diluted EPS calculated thereon.

Adjusted EPS before Amortization is defined as income from continuing operations, before special items and amortization, net of tax, and the diluted EPS calculated thereon. These non-GAAP measures should be used in addition to, but not as a substitute for, the analysis provided in the statement of operations. We believe that these measures are useful because they allow investors to evaluate our performance for different periods on a more comparable basis by excluding items that relate to acquired amortizable intangible assets and not to the ongoing operations of our businesses.

Adjusted Net Income is defined as income (loss) from continuing operations before special items. **Adjusted Net Income before Amortization** is defined as income (loss) from continuing operations before special items and amortization, net of tax. These non-GAAP measures should be used in addition to, but not as a substitute for, the analysis provided in the statement of operations. We believe that these measures are useful because they allow investors to evaluate our performance for different periods on a more comparable basis by excluding items that do not relate to the ongoing operations of our businesses.

Adjusted Operating Income is defined as operating income before special items. This non- GAAP measure should be used in addition to, but not as a substitute for, the analysis provided in the statement of operations. We believe this measure is useful because it allows investors to evaluate our operating results for different periods on a more comparable basis by excluding special items.

Adjusted OIBDA is defined as operating income before depreciation, amortization, restructuring and asset impairments, and special items.

Adjusted OIBDA Margin represents Adjusted OIBDA divided by non-equipment net operating revenues for Wireless and Adjusted OIBDA divided by net operating revenues for Long Distance. Although we have used substantially similar measures in the past, which we called "Adjusted EBITDA," we now use the term Adjusted OIBDA and Adjusted OIBDA Margin to describe the measure we use as it more clearly reflects the elements of the measure. These non-GAAP measures should be used in addition to, but not as a substitute for, the analysis provided in the statement of operations. We believe that Adjusted OIBDA and Adjusted OIBDA Margin provide useful information to investors because they are an indicator of the strength and performance of our ongoing business operations, including our ability to fund discretionary spending such as capital expenditures, spectrum acquisitions and other investments and our ability to incur and service debt. While depreciation and amortization are considered operating costs under generally accepted accounting principles, these expenses primarily represent non-cash current period allocation of costs associated with long-lived assets acquired or constructed in prior periods. Adjusted OIBDA and Adjusted OIBDA Margin are calculations commonly used as a basis for investors, analysts and credit rating agencies to evaluate and compare the periodic and future operating performance and value of companies within the telecommunications industry.

Free Cash Flow is defined as the change in cash and cash equivalents less the change in debt, investment in certain securities, proceeds from common stock, repurchase of the company's common stock and other financing activities, net, from continuing operations. This non-GAAP measure should be used in addition to, but not as a substitute for, the analysis provided in the statement of cash flows. We believe that Free Cash Flow provides useful information to investors, analysts and our management about the cash generated by our core operations after interest and dividends and our ability to fund scheduled debt maturities and other financing activities, including discretionary refinancing and retirement of debt and purchase or sale of investments.

Net Debt is consolidated debt, including current maturities, less cash and cash equivalents, current marketable securities and restricted cash. This non-GAAP measure should be used in addition to, but not as a substitute for, the analysis provided in the balance sheet and statement of cash flows. We believe that Net Debt provides useful information to investors, analysts and credit rating agencies about the capacity of the company to reduce the debt load and improve its capital structure.

Net Debt / Annualized Adjusted OIBDA is the ratio of long-term and current debt and capital lease obligations as of September 30, 2006 to Adjusted OIBDA for the third quarter of 2006 multiplied by four. This non-GAAP measure should be used in addition to, but not as a substitute for, the analysis provided in the statements of financial position and cash flows. We believe that this measure provides useful information to investors, analysts and credit rating agencies about the capacity of the company to reduce the debt loan and improve its capital structure.

Non-GAAP Reconciliations

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RECONCILIATIONS OF EARNINGS PER SHARE (Unaudited)

(millions, except per share data)

	As Reported				Pro Forma [c]			
	Quarter Ended		Year-to-Date		Quarter Ended		Year-to-Date	
	September 30, 2006	September 30, 2005	September 30, 2006	September 30, 2005	September 30, 2006	September 30, 2005	September 30, 2006	September 30, 2005
Income Available to Common Shareholders	$ 247	$ 514	$ 1,034	$ 1,583	$ 247	$ 407	$ 1,034	$ 1,377
Preferred stock dividends paid	-	2	2	5	-	2	2	5
Net Income (Loss)	247	516	1,036	1,588	247	409	1,036	1,382
Discontinued operations, net	-	(253)	(334)	(772)	-	(253)	(334)	(772)
Income from Continuing Operations	247	263	702	818	247	156	702	610
Special Items (net of taxes) [a]								
Restructuring and asset impairments	31	24	77	43	31	24	77	43
Merger and integration expense	66	149	181	166	66	204	181	248
Hurricane charges (excluding asset impairments)	-	49	-	49	-	49	-	49
Net gains on investment activities	-	(90)	(40)	(90)	-	(90)	(40)	(90)
(Gain) Loss on early retirement of debt	(4)	-	(9)	-	(4)	-	(9)	22
Tax audit settlement	(42)	-	(42)	-	(42)	-	(42)	-
Motorola consent fee	-	-	-	-	-	50	-	50
Adjusted Net Income*	$ 298	$ 395	$ 869	$ 984	$ 298	$ 393	$ 869	$ 932
Amortization (net of taxes)	650	276	1,792	281	650	504	1,792	1,492
Adjusted Net Income before Amortization*	$ 948	$ 671	$ 2,661	$ 1,265	$ 948	$ 897	$ 2,661	$ 2,424
Diluted Earnings Per Share	$ 0.08	$ 0.23	$ 0.35	$ 0.91	$ 0.08	$ 0.14	$ 0.35	$ 0.47
Discontinued operations	-	(0.11)	(0.11)	(0.45)	-	(0.09)	(0.11)	(0.26)
Earnings Per Share from Continuing Operations	0.08	0.12	0.24	0.46	0.08	$ 0.05	0.24	$ 0.21
Special Items	0.02	0.06	0.05	0.10	0.02	0.08	0.05	0.11
Adjusted Earnings Per Share* [b]	$ 0.10	$ 0.18	$ 0.29	$ 0.56	$ 0.10	$ 0.13	$ 0.29	$ 0.32
Amortization (net of taxes) [d]	0.22	0.12	0.60	0.16	0.22	0.17	0.60	0.50
Adjusted Earnings Per Share before Amortization* [b]	$ 0.32	$ 0.30	$ 0.89	$ 0.72	$ 0.32	$ 0.30	$ 0.89	$ 0.82

[a] See accompanying Notes to Financial Data for more information on special items.
[b] Earnings per share data may not add due to rounding.
[c] Pro forma consolidated information has been presented as if the Sprint Nextel merger occurred at the beginning of 2005. The 2006 periods reflect actual results.
[d] Rounding difference is pushed to this line.

Non-GAAP Reconciliations

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(millions)

For the Quarter Ended September 30, 2006	Consolidated	Wireless	Long Distance	Corporate & Eliminations
Operating Income (Loss)	$ 667	$ 702	$ 73	$ (108)
Special Items [a]				
Severance, lease exit costs and asset impairments	50	41	9	-
Merger and integration expense	107	-	-	107
Adjusted Operating Income*	824	743	82	(1)
Depreciation and amortization	2,540	2,416	124	-
Adjusted OIBDA*	3,364	3,159	206	(1)
Capital expenditures	1,843	1,473	255	115
Adjusted OIBDA* less Capex	$ 1,521	$ 1,686	$ (49)	$ (116)

For the Quarter Ended September 30, 2005	Consolidated	Wireless	Long Distance	Corporate & Eliminations
Operating Income (Loss)	$ 488	$ 572	$ 124	$ (208)
Special Items				
Severance, lease exit costs and asset impairments	37	16	21	-
Merger and integration expense	234	-	-	234
Hurricane charges	79	65	14	-
Adjusted Operating Income*	838	653	159	26
Depreciation and amortization	1,487	1,362	124	1
Adjusted OIBDA*	2,325	2,015	283	27
Capital expenditures	1,051	914	83	54
Adjusted OIBDA* less Capex	$ 1,274	$ 1,101	$ 200	$ (27)

For the Quarter Ended September 30, 2005	Pro forma Consolidated	Pro forma Wireless	Long Distance	Corporate & Eliminations
Operating Income (Loss)	$ 440	$ 608	$ 124	$ (292)
Special Items				
Severance, lease exit costs and asset impairments	37	16	21	-
Merger and integration expense	318	-	-	318
Hurricane charges	79	65	14	-
Adjusted Operating Income*	874	689	159	26
Depreciation and amortization	2,079	1,954	124	1
Adjusted OIBDA*	2,953	2,643	283	27
Capital expenditures	1,406	1,262	83	61
Adjusted OIBDA* less Capex	$ 1,547	$ 1,381	$ 200	$ (34)

[a] See accompanying Notes to Financial Data for more information on special items.

Non-GAAP Reconciliations

Sprint
Together with NEXTEL

(millions)

For the Quarter Ended June 30, 2006	Consolidated	Wireless	Long Distance	Corporate & Eliminations
Operating Income (Loss)	$ 712	$ 660	$ 155	$ (103)
Special items				
Severance, lease exit costs and asset impairments	40	33	7	-
Merger and integration expense	113	-	-	113
Adjusted Operating Income*	865	693	162	10
Depreciation and amortization	2,354	2,242	113	(1)
Adjusted OIBDA*	3,219	2,935	275	9
Capital expenditures	1,359	1,064	200	95
Adjusted OIBDA* less Capex	$ 1,860	$ 1,871	$ 75	$ (86)

For the Quarter Ended March 31, 2006	Consolidated	Wireless	Long Distance	Corporate & Eliminations
Operating Income (Loss)	$ 484	$ 436	$ 104	$ (56)
Special items				
Severance, lease exit costs and asset impairments	38	28	10	-
Merger and integration expense	76	-	-	76
Adjusted Operating Income*	598	464	114	20
Depreciation and amortization	2,346	2,223	122	1
Adjusted OIBDA*	2,944	2,687	236	21
Capital expenditures	1,243	1,071	92	80
Adjusted OIBDA* less Capex	$ 1,701	$ 1,616	$ 144	$ (59)

[a] See accompanying Notes to Financial Data for more information on special items.

Non-GAAP Reconciliations

Sprint
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RECONCILIATIONS OF EARNINGS PER SHARE (Unaudited)

(millions, except per share data)

	As Reported Quarter Ended June 30, 2006
Income Available to Common Shareholders	$ 370
Preferred stock dividends paid	-
Net Income (Loss)	370
Discontinued operations, net	(79)
Income from Continuing Operations	291
Special items (net of taxes) [a]	
Severance, lease exit costs and asset impairments	23
Merger and integration expense	69
Net gains on investment activities	(8)
(Gain) Loss on early retirement of debt	(5)
Adjusted Net Income*	$ 370
Amortization (net of taxes)	577
Adjusted Net Income before Amortization*	$ 947
Diluted Earnings Per Share	$ 0.12
Discontinued operations	(0.02)
Earnings Per Share from Continuing Operations	0.10
Special items	0.02
Adjusted Earnings Per Share* [b]	$ 0.12
Amortization (net of taxes)	0.20
Adjusted Earnings Per Share before Amortization*	$ 0.32

Non-GAAP Reconciliations

Sprint
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(millions)

	Quarter Ended			Year-to-date	
	September 30, 2006	June 30, 2006	September 30, 2005	September 30, 2006	September 30, 2005
Wireless Pro Forma					
Adjusted OIBDA*	$ 3,159	$ 2,935	$ 2,643	$ 8,781	$ 7,616
Service, wholesale, affiliate and other net operating revenues	8,229	7,800	7,249	23,714	21,243
Adjusted OIBDA margin*	38.4%	37.6%	36.5%	37.0%	35.9%
Operating income	$ 702	$ 660	$ 608	$ 1,798	$ 1,727
Operating income margin	8.5%	8.5%	8.4%	7.6%	8.1%
Long Distance					
Adjusted OIBDA*	$ 206	$ 275	$ 283	$ 717	$ 801
Total net operating revenues	1,626	1,641	1,735	4,936	5,172
Adjusted OIBDA margin*	12.7%	16.8%	16.3%	14.5%	15.5%
Operating income	$ 73	$ 155	$ 124	$ 332	$ 395
Operating income margin	4.5%	9.4%	7.1%	6.7%	7.6%
Consolidated Pro Forma					
Adjusted OIBDA*	$ 3,364	$ 3,219	$ 2,953	$ 9,527	$ 8,493
Service, wholesale, affiliate and other net operating revenues	9,653	9,290	8,881	28,187	26,132
Adjusted OIBDA margin*	34.8%	34.7%	33.3%	33.8%	32.5%
Operating income	$ 667	$ 712	$ 440	$ 1,863	$ 1,807
Operating income margin	6.9%	7.7%	5.0%	6.6%	6.9%

Non-GAAP Reconciliations

Sprint
Together with NEXTEL

(millions)

	Quarter Ended		Year-to-Date	
	September 30, 2006	September 30, 2005	September 30, 2006	September 30, 2005
Adjusted OIBDA*	$ 3,364	$ 2,325	$ 9,527	$ 5,268
Adjust for special items	(157)	(350)	(424)	(408)
Proceeds from communications towers lease transactions	-	-	-	1,195
Other operating activities, net [a]	(303)	(711)	(1,511)	(839)
Capital expenditures	(1,885)	(1,051)	(4,798)	(2,365)
Dividends paid	(74)	(74)	(224)	(447)
Proceeds from sales of assets	54	378	211	589
Other investing activities, net	(230)	284	(443)	831
Free Cash Flow*	769	801	2,338	3,824
Decrease in debt, net	(1,783)	(9)	(5,746)	(1,024)
Retirement of redeemable preferred shares	-	-	(247)	-
Purchase of treasury shares	(1,523)	-	(1,523)	-
Cash transferred to Embarq, net of cash received and proceeds from the sale of Embarq notes	-	-	6,268	-
Discontinued operations activity, net [b]	-	68	367	83
Cash acquired in Nextel merger, net of cash paid	-	1,183	-	1,183
Purchase of PCS Affiliates, Nextel Partners and Velocita, net of cash acquired	(867)	(949)	(10,483)	(949)
Change in restricted cash	1,124	-	93	-
Distributions from unconsolidated investees, net	-	181	-	181
Investments in debt securities, net	91	134	1,128	49
Proceeds from common shares issued	46	187	372	293
Other financing activities, net	12	7	12	12
Change in cash and cash equivalents - GAAP	$ (2,131)	$ 1,603	$ (7,421)	$ 3,652

	September 30, 2006
Total Debt	$ 21,961
Less: Cash on hand	(1,482)
Less: Current marketable securities	(626)
Net Debt*	$ 19,853

[a] Other operating activities, net includes the change in working capital, change in deferred income taxes, miscellaneous operating activities and non-operating items in net income (loss).

[b] Discontinued operations activity, net includes $8.6 billion from the issuance of long-term debt.

Non-GAAP Reconciliations

Sprint
Together with NEXTEL

		As of September 30, 2006
Total Debt	$	21,961
Less: Cash on Hand		(1,482)
Less: Current Marketable Securities		(626)
Net Debt *	$	19,853
Pro Forma Net Debt	$	19,853
Adjusted OIBDA for the three months ended, September 30, 2006	$	3,364
		* 4
Annualizd Adjusted OIBDA *	$	13,456
Pro Forma Net Debt/Annualized Adjusted OIBDA *		**1.5**

EXHIBIT CO 0738

Investor Relations
Company Profile ›
Business Segments
Overview
Wireline
Domestic Wireless
Corporate Governance ›
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WorldCom Information
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Investor Relations \ Business Segments

Domestic Wireless

The domestic wireless business, operating as Verizon Wireless, provides wireless voice and data products and services across the United States using one of the most extensive wireless networks.

We have detected that your browser is not equipped with Flash Player, version 8. This is required to view the "investor.verizon.com" site. To get the updated Flash Player, please click Install Now in the dialog box below. You will not have to reboot your machine.

Install Now

Financial	2004	2005
	(Dollars in Millions)	
Revenues	27,662	32,301
Expenses	21,824	24,921
Operating Income	5,838	7,380
Operating Income Margin	21.1%	22.8%

Operations	As of 9/30/06
Customers (000)	56,747
Penetration	22.2%
Customer Net Adds for current period (000)	1,912
Total churn, including prepaid	1.2%

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Review Q3 2(
› Non-GAAP I
› Earnings We
› Presentatior
› Quarterly Bu

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EXHIBIT CO 0739

Company Overview

Cingular at a glance

We're larger, more agile and better prepared than ever to reinvent the way the world communicates. Get all the facts on our business, our growth, our vision and more.

About Our Company

Cingular Wireless is the largest wireless company in the United States, with more than 58 million subscribers who use the nation's largest digital voice and data network. Cingular is dedicated to providing customers with wireless technology designed to enrich their lives.

Our Vision

To be the most highly regarded wireless company in the world, with a driving focus around best-in-class sales and service.

Company Ownership

Cingular Wireless is a joint venture between the domestic wireless divisions of AT&T (NYSE:T) and BellSouth (NYSE: BLS). AT&T owns 60 percent of the company and BellSouth owns 40 percent, based on the value of the assets both contributed to the venture.

Where is Cingular located?

Just about everywhere.

Cingular Locations

Headquarters

Atlanta, GA	Dallas, TX	Redmond, WA

Transaction Processing Center

El Paso, TX

Call Centers

Little Rock, AR	Schaumburg, IL	Johnson City, TN
Anaheim Hills, CA	Springfield, IL	Memphis, TN
Atwater, CA	Ashland, KY	Austin, TX
Sacramento, CA	Baton Rouge, LA	Dallas, TX
Miami, FL	Lafayette, LA	Lubbock, TX
Ocala, FL	Ocean Springs, MS	Midland, TX

Orlando, FL	Fayetteville, NC	Wichita Falls, TX
Atlanta, GA	Harrisburg, PA	Lebanon, VA
Cedartown, GA	Oklahoma City, OK	Bothell, WA
Rantoul, IL	Tulsa, OK	Cerritos, CA
Paramus, NJ	Ridgeland, MS	Portland, OR
Greensboro, NC	Bloomington, MN	Mililani, HI

Telesales Centers

Birmingham, AL	Jacksonville, FL	Nashville, TN

Retail Locations

Cingular has retail locations in approximately 45 states and Puerto Rico.

Learn More

Further details about our company can be found on About and throughout Cingular.com.

Cingular Wireless is an Affirmative Action/Equal Opportunity Employer, and we're committed to hiring a diverse and talented workforce. EOE/AA/M/F/D/V.

http://www.cingular.com/about/careers/overview.jsp

EXHIBIT CO 0740

MSNBC.com
Newsweek

Q&A: Jobs on iPod's Cultural Impact

With iPod's fifth birthday around the corner, Steve Jobs discusses the MP3 player's design, the cool factor and the impact on how we listen to music.

WEB EXCLUSIVE
By Steven Levy
Newsweek
Updated: 4:54 p.m. ET Oct 16, 2006

Oct. 15, 2006 - Oct. 23 marks the fifth anniversary of Apple's iPod. CEO Steve Jobs reflected with NEWSWEEK's Steven Levy (author of "The Perfect Thing," a book about the iPod out this month) about the past, present and future of the device that changed Apple—and the world.

NEWSWEEK: During the iPod's development process did you get a sense of how big it would become?
Steve Jobs: The way you can tell that you're onto something interesting is if everybody who knows about the project wants one themselves, if they can't wait to go out and open up their own wallets to buy one. That was clearly the case with the iPod. Everybody on the team wanted one.

Other companies had already tried to make a hard disk drive music player. Why did Apple get it right?
We had the hardware expertise, the industrial design expertise and the software expertise, including iTunes. One of the biggest insights we have was that we decided not to try to manage your music library on the iPod, but to manage it in iTunes. Other companies tried to do everything on the device itself and made it so complicated that it was useless.

What was the design lesson of the iPod?
Look at the design of a lot of consumer products—they're really complicated surfaces. We tried make something much more holistic and simple. When you first start off trying to solve a problem, the first solutions you come up with are very complex, and most people stop there. But if you keep going, and live with the problem and peel more layers of the onion off, you can oftentimes arrive at some very elegant and simple solutions. Most people just don't put in the time or energy to get there. We believe that customers are smart, and want objects which are well thought through.

Some people say that iPod might lose its cachet because it's too popular—how can it be cool when Dick Cheney and Queen Elizabeth have one?
That's like saying you don't want to kiss your lover's lips because everyone has lips. It doesn't make any sense. We don't strive to appear cool. We just try to make the best products we can. And if they are cool, well, that's great.

What products, maybe outside technology, do you consider cool?
I like things that do the job and kind of disappear into my life. Like Levis. They just kind of get faded and disappear, and you don't think about it much. If you look, you appreciate the design, but you feel something from them, too. A lot of quality is communicated through a feeling that people have. They don't understand exactly why, but they know that a lot of care and love was put into the designing of the product.

Let's talk about the iTunes store. How did you get the record labels, which had been resisting digital music, to sign up?
It was a process over 18 months. We got to know these folks and we made a series of predictions that a lot of things they were trying would fail. Then they went and tried them, and they all failed, for the reasons that we had predicted. We kept coming back to visit them every month or two, and they started to believe that we might actually have some insight into this, and our credibility grew with them to the point where they were willing to take a chance with us. Now, remember, it was initially just on the Mac, so one of the arguments that we used was, "If we're completely wrong and you completely screw up the entire music market for Mac owners, the sandbox is small enough that you really won't damage the overall music industry very much." That was one instance where Macintosh's [small] market share helped us. Then about six months later we

were able to successfully persuade them to take down the barriers and let us move it out to the whole market.

Now people at some labels think that iTunes, with its dominant market share has too much power.
We've never once gone to them and asked them to lower their prices.

No, but you've asked them not to raise their prices, when some of them wanted to.
Our core initial strategy on the store was that if you want to stop piracy, the way to stop it is by competing with it, by offering a better product at a fair price. In essence, we would make a deal with people. If they would pay a fair price, we would give them a better product and they would stop being pirates. And it worked. If we go back now and we raise prices—this is what we told the record companies last year—we will be violating that implicit deal. Many [users] will say, "I knew it all along that the music companies were gonna screw me, and now they're screwing me." And they would never buy anything from iTunes again.

Do you think that it's fair to the customer that the songs they buy from Apple will only work on iTunes and the iPod?
Well, they knew that all along.

At one point you were saying, "When our customers demand it, that's when we'll consider interoperability."
Nobody's ever demanded it. People know up front that when they buy music from the iTunes music store it plays on iPods, and so we're not trying to hide anything there.

Microsoft has announced its new iPod competitor, Zune. It says that this device is all about building communities. Are you worried?
In a word, no. I've seen the demonstrations on the Internet about how you can find another person using a Zune and give them a song they can play three times. It takes forever. By the time you've gone through all that, the girl's got up and left! You're much better off to take one of your earbuds out and put it in her ear. Then you're connected with about two feet of headphone cable.

IPods now have video, games, audio books and podcasts. Will iPods always be about the music?
Who knows? But it's hard to imagine that music is not the epicenter of the iPod, for a long, long, long, long, long time. I was very lucky to grow up in a time when music really mattered. It wasn't just something in the background; it really mattered to a generation of kids growing up. It really changed the world. I think that music faded in importance for a while, and the iPod has helped to bring music back into people's lives in a really meaningful way. Music is so deep within all of us, but it's easy to go for a day or a week or a month or a year without really listening to music. And the iPod has changed that for tens of millions of people, and that makes me really happy, because I think music is good for the soul.

URL: http://www.msnbc.msn.com/id/15262121/site/newsweek/

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Microsoft
FUJIFILM CORPORATION TRACKS 24x7 SALES DATA IN OVER 200 COUNTRIES, WITH MICROSOFT SQL SERVER 2005.
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iPod Continues to Dominate Industry

By BetaNews Staff, BetaNews

August 17, 2006, 1:30 PM

Apple continued to dominate the digital music player industry in the second quarter, data from the NPD Group indicated Thursday. The iPod had a 75.6 percent share in the United States, over eight times more than its nearest competitor. Following Apple was SanDisk, with 9.7 percent, and Creative with a 4.7 percent share. Rounding out the top five were Samsung and Sony, with a 2.5 and 1.9 percent market share, respectively.

NPD Group warned, however, that Apple's dominance may begin to crumble as more mobile phone manufacturers begin to integrate music player functionality into their devices. Still, the analyst firm said the industry should be able to hold its own as standalone players offer more features, capacity, better DRM support, and easier user interfaces when compared to phones.

EXHIBIT CO 0742

THE BUSINESS OF TECHNOLOGY

iTunes Profits, Labels Stew

While Apple celebrates its first profit from its iTunes store, music labels seek pricing changes.

April 20, 2006

After two-and-a-half years of losses, Apple's iTunes Music Store showed a profit in the most recently completed quarter, and while that buoys Apple's fortunes, it is hardly good news for the struggling music industry.

Apple said Wednesday the world's best known and busiest music download store went just past the breakeven point, perhaps based on the growing popularity of video downloads, which topped 15 million recently (see Apple Profits Jump 41%).

"The fact that iTunes took this long to turn a profit shows that there is not a lot of money to be made out of $0.99 singles," said Mark Mulligan, research director of JupiterResearch. "Apple is the market leader with the ability to offset its fixed costs through volume, and even with that, it took them this long to reach profitability."

Mr. Mulligan is not convinced that iTunes turned a profit at all because the company may not be allocating all the relevant marketing costs to the iTunes bottom line. It is tough to distinguish what is an iTunes marketing cost from marketing costs for the iPod, Apple's best-selling digital music player.

"If iTunes with all of its leadership advantages is struggling to make it to true profitability, what chances are there for the smaller niche competitor?" he asked.

Apple's insistence on a single price across all products, which the music labels have battled tooth and nail, is not a workable business proposition for the music labels, according to Mr. Mulligan.

"The fact is, iTunes is a tool to sell iPods," he said. "Apple can afford to offset its losses against the sales of devices. Only companies that can afford to swallow the cost of digital music to sell their core products, like ISPs selling data access, can prosper in this market."

Apple could not be immediately reached for comment.

Shares of Apple rose $1.61 to $67.26 in recent trading on the Nasdaq.

Industry Transition

As the music labels transition from physical sales of CDs to digital music sales, they have expressed concerns that the leading provider of digital music, Apple, has stubbornly persisted in setting a single $0.99 price, using their content to sell its hardware.

All of the top four music labels—Universal, Warner Music Group, SonyBMG, and EMI North America—have attempted to renegotiate their deals with Apple, but so far they have failed to convince Apple to shift to variable pricing (see Apple to Raise iTunes Prices?).

"The music industry has to determine what it wants digital music to be: a marketing tool or a viable, realistic alternative distribution platform," said Mr. Mulligan. "As long as the business model is maintained in its current structure, it is heavily skewed against companies looking to make a profit from selling music."

A couple of the record labels have gone into the retail business themselves, but it has proven to be a bad fit because the consumer buys based on the artists, not the labels, he said. Each label will have a severely limited catalog of its own artists, he added.

"A label such as Motown might be able to pull that off, but not many others," said Mr. Mulligan. "Music

fans are label-agnostic. And retail is not the core competence of music labels."

The record labels are still the gatekeepers, he said, and the percentage of their sales from digital retail is rapidly headed toward double figures, so they must take some strong measures to secure that business.

"The record labels have the power to determine what the digital music business should look like," said Mr. Mulligan. "Apple is a player, but it is one player, and it depends on the output of the music industry. If they want variable digital music pricing, they have the wherewithal to make that a reality."

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EXHIBIT CO 0743

m:metrics

M:Metrics Press Release

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FOR IMMEDIATE RELEASE

M:METRICS BENCHMARK SURVEY: WHEN IT COMES TO RING(TONE) SHOPPING, MALES AND FEMALES PREFER DIFFERENT BLING

Ringtones are fashion, mobile music is another gadget.

San Francisco—September 26, 2005—As the wireless and entertainment industries gather for CTIA's annual Wireless IT and Entertainment Conference, M:Metrics, the authority on the consumption of mobile content and applications, reveals new insights on ringtones and mobile music. The measurement firm reports that although ringtones are universally popular among both males and females, there are significant differences between the sexes when it comes to the types of mobile music downloads.

M:Metrics' August Benchmark Survey found that whereas females are significantly less likely to use most mobile data services compared with male counterparts, they are about 6 percent more likely to download ringtones, representing 52.6 percent of mobile subscribers who purchased at least one in the quarter ended August 2005. Females predominate in certain music genres for ringtones and are 60 percent more likely to purchase a pop ringtone than are males, for example. Males are 68 percent more likely to choose a hard rock or heavy metal ringtone. Overall, hip-hop is the most popular genre across both genders, accounting for 20 percent of all downloads and just beating the rock or alternative category as the most popular genre for males.

"Mobile phones are used in a social context, and as such the phone a consumer carries makes a personal statement. Mobile phone users—particularly youth and young adults—turn to ringtones as a form of social expression," observed Mark Donovan, vice president, product and senior analyst. "This data indicates that the female predilection to accessorize extends beyond the material world: women are picking up the hottest pop ringtone like they would a new pair of shoes or handbag. Males, on the other hand, prefer to project their masculinity through their preference for hard rock and non-musical ringtones, such as sound effects and celebrity voices or movie clips."

Interestingly, whereas females rule in ringtone consumption, males are leading in the adoption of ringback services.

continued

M:Metrics found that males are 16 percent more likely to have subscribed to a ringback subscription in August, and were 25 percent more likely to have previously subscribed to a ringback subscription that they had since canceled at the time of the survey.

"The ringback data illustrates a consistent finding with new mobile technologies," noted Donovan. "Although ringbacks are a form of personalization, today they are first and foremost a novel technology, and males are consistently more likely to embrace new technologies and gadgets. We see this trend reflected in data we collected about attitudes toward mobile music."

Although the market for music on mobile phones is only beginning to emerge in the U.S., M:Metrics' latest survey also reveals early insights on consumers' intentions to consume mobile music.

Mobile subscribers appear most interested in moving music tracks from their computer to their phone, with 12.7 percent indicating they are likely to do so in the coming year. Less than 9 percent of mobile subscribers reported that they were likely to subscribe to a mobile music service in the next 12 months. In each scenario, males comprised a majority of those who indicated interest in using their mobile phone as a music device.

The chart below depicts the findings from M:Metrics' August Benchmark Survey, the largest and most accurate monthly measures of mobile content consumption. The chart that follows shows the most popular ringtone genres.

US Mobile Subscriber Monthly Consumption of Content and Applications
M:Metrics Benchmark Survey: August 2005

Activity	Projected Monthly Reach (000s)	Percent US Mobile Subscribers	Change from Previous Survey
Sent or Received Text Message	66,900	37.0%	-1.0%
Retrieved News and Information Via Browser	25,263	14.0%	3.9%
Used Personal E-mail	20,921	11.6%	2.8%
Used Photo Messaging	20,394	11.3%	8.8%
Purchased Ringtone	16,578	9.2%	-5.5%
Used Mobile Instant Messenger	18,227	10.1%	4.9%
Used Work E-mail	11,038	6.1%	5.5%
Purchased Wallpaper or Screensaver	6,676	3.7%	-4.0%
Downloaded Mobile Game	6,195	3.4%	-0.6%

Source: M:Metrics, Inc., Copyright © 2005. Survey of U.S. mobile subscribers. Data based on three-month moving average for period ending August 31, 2005, n= 42,173.

Continued

Ringtone Genre	Total Subscribers (000s)	Males (000s)	Benchmark Index	Females (000s)	Benchmark Index
Hip Hop or Rap	4,704	2,232	97	2,472	103
Rock or Alternative	4,301	2,219	106	2,082	95
Pop	3,113	1,044	69	2,069	130
TV/Movie/Game Themes	2,532	1,161	94	1,371	106
Classic Rock	1,867	949	104	918	96
Country	1,494	507	70	987	129
Hard Rock or Heavy Metal	1,279	840	135	438	67
Other	1,005	377	77	627	122
Oldies	640	296	95	345	105
Dance or Electronic	565	310	112	255	88

Source: M:Metrics, Inc., Copyright © 2005. Survey of U.S. mobile subscribers. Data based on three-month moving average for period ending August 31, 2005, n= 42,173.

About M:Metrics

M:Metrics is the mobile industry authority on the measurement of the consumption, availability and feasibility of mobile content and applications. M:Metrics' monthly syndicated data services benchmark the performance of carriers, handset OEMs, platform vendors and content providers, empowering decision makers with highly granular, verifiable measures of subscriber consumption, content availability and pricing and handset capabilities. M:Metrics, Inc. is a private, venture-funded corporation headquartered in Seattle, Washington with offices in San Francisco, California.

About M:Metrics Data

Based on continually refreshed samples of nationally representative mobile phone consumers, M:Metrics reports summarize market size, device reach, and key demographic and mobile phone usage characteristics.

The data presented here is drawn from an extensive survey questionnaire that collects specific device model and carrier subscription information from each month's sample of mobile phone subscribers, and also drills down into specific details related to current and past usage of various mobile phone applications and content. Data collected from each sample are statistically balanced and projected to the total national population of mobile phone subscribers.

Authorized Uses

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EXHIBIT CO 0744

offering a high-quality alternative to illegal file-sharing sites which are often characterized by poor-quality music, missing song details and spyware.

The industry's overall perception of what constitutes piracy has not changed, Kent stated. By supporting our service that provides people with a compelling alternative experience and lets them enjoy high-quality music they've legally downloaded, Universal and EMI Music Publishing have enabled SpiralFrog to move the music industry barometer. Launching later this year, SpiralFrog offers users of its no-cost service the ability to legally download music by many of the world's most popular and award-winning artists. Its target audience is people between the ages of 13 and 34, who the company plans to attract by creating a music-centric experience and destination that is second to none.

###

About EMI Music Publishing
EMI Music Publishing is the world's most creative music publisher with more than one million copyrights including some of the best known songs ever written: "New York, New York", "Over The Rainbow" and "Singin' In The Rain". Its current hit-making writers and producers include: Arctic Monkeys, Fergie of Black Eyed Peas, Natasha Bedingfield, James Blunt, Kelly Clarkson, Jermaine Dupri, Eminem, Enya, Nelly Furtado, Gorillaz, Jay-Z, Alicia Keys, Rihanna, Eros Ramazzotti, Kanye West and Pharrell Williams. www.emimusicpub.com

About SpiralFrog
SpiralFrog (www.spiralfrog.com) is the new online music destination offering advertising-supported legal downloads of audio and video content licensed from the catalogs of the world's leading record labels and from independents. SpiralFrog offers music-lovers a compelling alternative to illegal file-sharing and pirate sites, with a secure environment for them to satisfy their unyielding passion and thirst for music, entertainment, information and brands at no cost except for their time and attention. Headquartered in New York, SpiralFrog will launch its advertising-supported service in beta in late 2006.

SpiralFrog and Universal Music Group Partner in Advertising-Supported Legal Music Download Service

New York, August 29, 2006 SpiralFrog, the new music download destination, has signed an agreement with Universal Music Group (UMG), the world's leading music company, to make UMG's extensive catalog available for legal downloading in the US and Canada via SpiralFrog's advertising-supported service.

SpiralFrog will offer users of its no-cost web-based service the ability to legally download music by many of the world's most popular and award-winning artists.

"Offering young consumers an easy-to-use alternative to pirated music sites will be compelling," said Robin Kent, SpiralFrog's CEO. "SpiralFrog will offer those consumers a better experience and environment than they can get from any pirate site." Kent highlighted some key factors - legal digital files with no viruses or spyware in a controlled client-server architecture, quick downloading, and quality songs and music videos by great artists as among the primary benefits users will gain.

Digital rights management technology is built-in to all audio and video content as part of measures the company and its partners are actively taking to address piracy. "We want to provide the best environment for everyone - our partners and the recording artists, as well as consumers," Kent said. "Piracy continues to be one of the biggest issues facing the music industry where illegal file sharing and unauthorized CD burning are the prime means of music piracy. Digital rights protection will help us combat piracy and provide peace of mind for the record labels and the artists."

For Universal Music Group and other record labels, the service will also be compelling, Kent said. "Offering legally-authorized audio and video downloads in an advertising-

supported environment works, as our business model is based on sharing our income streams from that advertising with our content partners like Universal."

Kent noted that the company's research revealed that consumers are more than willing to 'pay' for their content by watching non-intrusive, contextually-relevant, targeted advertising in an online entertainment environment where advertising is already part of the overall experience.

"We believe SpiralFrog will deliver an audience we highly desire and need to reach," said Oscar Feldenkreis, Vice-Chairman, President and COO at Perry Ellis International, Inc. "Our audience is heavily into music and can be more easily reached on the web. We see SpiralFrog as an ideal place for us to communicate and build lasting relationships with our core audience and which give us unique new revenue opportunities."

Andrew McLean, Chief Client Officer Global at Mediaedge:cia, commented, "The challenge is to find ways to integrate messaging and content to engage and add value to consumers' lives rather than just add to the message clutter out there. Companies like SpiralFrog offer a more direct engagement opportunity and have the potential to be of value to consumers and, as a result, our clients." Mediaedge:cia is a unit of GroupM, the media investment management arm of WPP Group, one of the world's largest communications services groups.

"Our target audience is the driving force behind the changes in how music is created, discovered and consumed," Kent said. "They are the future of music. We believe SpiralFrog's differentiated offering will be highly appealing to them as well as to content providers."

SpiralFrog's target audience - people between the ages of 13 and 34 - is an advertiser's dream, Kent added. "This is the core audience we will attract by building a music-centric experience and destination that is second to none, legally delivering what the majority of users want - content they pay for only with their time. It's content that advertisers are willing to pay for on their behalf."

SpiralFrog will launch in beta later this year.

About SpiralFrog

SpiralFrog (www.spiralfrog.com) is the new online music destination offering advertising-supported legal downloads of audio and video content licensed from the catalogs of the world's leading record labels and from independents. SpiralFrog offers music-lovers a compelling alternative to illegal file-sharing and pirate sites, with a secure environment for them to satisfy their unyielding passion and thirst for music, entertainment, information and brands at no cost except for their time and attention.

Headquartered in New York, SpiralFrog will launch its advertising-supported service in beta in late 2006.

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DoJ probes Big Music downloads

p2p news / p2pnet: The US Department of Justice has followed New York attorney general Eliot Spitzer's lead by opening an investigation into the prices the major record labels are charging for their lossy digital music files.

In the firing line are Warner Music Group, EMI Group Plc, Vivendi Universal's Universal Music Group and Sony BMG, the members of the Organized Music cartel.

In 2004, the Big Four were ordered to pay $50 million to musicians they'd had under contract and more recently, Spitzer was looking into bribery charges. "Major artists, major songs were sent up the charts through improper payments to buy spins on the air that translated into sales," his office said.

In this new federal investigation, "One music industry source said some subpoenas may have been issued already in connection with the probe, while other labels had been tipped off that subpoenas would likely be coming in the next few days, says Reuters. "It appeared that Sony BMG had already received a subpoena, the second industry source said."

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Label capos weren't available, "or declined to comment."

The Big Four currently wholesale 'product' at between about 65 and 80 cents per download. This forces corporate music sites such as Apple's iTunes to try to get $1 and more for each track.

Most music lovers are refusing to be ripped off in this way, instead using to the p2p networks and independent sites for their music fixes.

Sony BMG, *et al*, are, in turn, trying to sue their customers into buying downloads.

Also See:

bribery charges - **9 radio stations in bribery probe,** February 9, 2006
Reuters - **DOJ opens probe into online music pricing: sources,** March 3, 2006

(Friday 3rd March 2006)

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T-Mobile USA has 20 Million subscribers

Updated by W2forum Research thu, 22nd sep 2005 in **Mobile Facts & Stats**

T-Mobile USA reported that it has reached 20 million subscribers. The carrier said it has doubled its subscriber base in the last 10 quarters. T-Mobile attributes the rapid growth to its offering more

minutes, features, and service to subscribers. The top carrier in the US is Cingular Wireless with a customer base of 51.6 million, followed by Verizon Wireless with 47.4 million, and Sprint Nextel with roughly 40 million. Although, T-Mobile is a distant fourth, it added 972,000 new customers last quarter and continues to post impressive growth.

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UMG and BMG increase their world market shares but EMI is the most profitable major

MUSIC & COPYRIGHT's ninth annual survey of the market shares of the five major international record companies shows that in 2002 UMG remained the clear leader with a 24.6% share of the global soundcarrier market (*see table below*). The survey includes the world's 20 largest soundcarrier markets plus a further 18 markets. Collectively these 38 territories accounted for almost 98% of the trade value of global soundcarrier sales in 2002. For the first time MUSIC & COPYRIGHT has calculated the majors' market shares on the basis of their wholly owned repertoire (*see below*).

In 2002 UMG increased its market share by over one percentage point from 23.5% to 24.6%, giving it a lead of almost 10 percentage points over second-placed SME, in 2002. The only other major to significantly increase its market share was BMG. When the market share of BMG, which has always been the smallest of the five majors, fell to a little over 8% in 2000 and 2001 (*see the historical table of market shares on page 7*) it seemed that four distinct tiers were emerging, with UMG well ahead of SME, which in turn was significantly ahead of EMI and WMG, which in turn had a significant lead over BMG. However, in 2002, BMG increased its market share from 8.2% to 9.8%, while EMI lost market share and WMG's sales were flat. As a result the gap between third placed EMI and fifth placed BMG was only 2.2 percentage points in 2002, compared to 4.8 percentage points in 2001.

As global soundcarrier sales have started to decline, the previously close relationship between market share and profitability has been broken. UMG's market dominance was, until very recently, accompanied by a higher level of profitability than that of the other major international record companies. Size seemed to matter as economies of scale and high sales led to large profits. However, as the tables on page 3 show, there was very little relationship between the sales, profitability and market shares of the majors in 2002. For example, despite its increased market share, UMG's sales and profitability fell in 2002. In contrast, EMI's operating profits rose by 33% to $412.7m despite an 11% fall in sales in the year to April 2003 (*see* M&C 251/5). BMG also reported lower sales but higher operating profits, while WMG, which recorded a marginal increase in market share (from 11.8% to 11.9%), saw both its profits and sales rise. Indeed EMI, whose global share dropped the most, from 13% to 12%, had the highest profit margin (*see table on page 3*). One reason for the increased profits of BMG, EMI and WMG in 2002 was that they saw the benefits of cost-cutting exercises they had put in place earlier. In contrast, UMG, which had greatly benefited from economies of scale and cost reductions following its 1999 takeover of PolyGram, saw those benefits end in 2002. SME, which only recently inaugurated a set of cost-cutting and restructuring measures, has yet to see the direct economic benefit of them. SME, which only recently inaugurated a set of cost-cutting and restructuring measures (*see* M&C 250/10), has yet to see the economic benefits of its cost savings.

The majors' continued concern with cost-cutting and restructuring explains the renewed attempts of the three smaller majors to effect some form of merger or shared ownership deal between two of their number. In 2000 WMG tried to buy EMI and then, when that failed, EMI attempted a merger with BMG. Both proposed deals, which were blocked by the US and EU regulatory authorities, were driven mainly by a search for the economies of scale that UMG had achieved after its cre-

continued on page 2 ▶

The majors: Global market shares in 2002 (%)

BMG		EMI		SME		UMG		WMG	
9.8	(8.2)	12.0	(13.0)	14.8	(14.7)	24.6	(23.5)	11.9	(11.8)

The figures in brackets are the market shares for 2001.

Source: MUSIC & COPYRIGHT research.

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Market shares

ation at the end of 1998. However, there is a significant difference between these putative deals and Seagram's acquisition of PolyGram, which led to the creation of UMG. UMG was created at a time of global soundcarrier market growth. The WMG-EMI and EMI-BMG merger attempts were made at a time when the soundcarrier market was in decline (*see table on page 7*). Sales data from several soundcarrier markets to date (*see page 7*) show that this decline has accelerated so far in 2003. All the indications are that the decline will continue into 2004.

The realisation that the decline in the soundcarrier market is not a short-term matter has led the majors to implement cost-cutting programmes and explore merger possibilities. Over the last six months there has been press speculation linking all five majors to some form of outright sale (notably UMG) or merger. In the last three months there have been reports that different combinations of two of BMG, EMI and WMG, which now have similar market shares, have held talks about merging all or significant parts of their operations. The implication has been that a merger of two of these small majors – with BMG and WMG recently identified as the most keen to merge – would bring the required critical mass and allow for further restructuring and cost-cutting thus delivering increased profits. There is a widespread assumption that such a merger would be the last to be permitted by competition authorities (which, for a variety of reasons, have changed their attitude towards such a merger since 2000) would leave the remaining smallest major unable to undergo any more restructuring beyond simple internal cost-cutting and divestments. The general consensus is that it would not be permitted to merge with any othe other majors because the competition authorities would balk at almost the entire music market being controlled by three major companies. Investors reacted to this scenario by selling EMI shares last month, despite its improved profitability.

As the first column of the table on the right shows, the company created as the result of a merger between any two of BMG, EMI and WMG would have a market share of almost 22%. However, the new company would still be smaller than UMG. Indeed, even adding the estimated 1.5 percentage points in wholly owned repertoire market share that BMG will gain this year following its purchase of Zomba, both BMG-EMI (at 23.3%) and BMG-WMG (at 23.2%) would still be smaller than UMG.

Nonetheless, a merger between any two of the three smaller companies would allow considerable scope for cost cutting. Analysts have suggested that a merger between BMG and WMG could save each company $250m a year. Much of that saving would come from the integration of back office activities, but some would come from withdrawing from distribution and manufacturing, a move which BMG and WMG, to varying degrees, have already started. Despite the short term profitability of manufacturing DVDs, the majors increasingly see manufacturing as a non core activity.

Estimated market shares of combinations of BMI, EMI, WMG and Zomba (%)

BMG + EMI	21.8	BMG + EMI + Zomba	23.3
BMG + WMG	21.7	BMG + WMG + Zomba	23.2
EMI + WMG	23.9		

Source: music & copyright research

The majors' new focus on the creation of copyrights is one reason why MUSIC & COPYRIGHT's market shares for 2002 have been calculated on the basis of wholly-owned repertoire only. In the past the majors have been ambivalent about whether they preferred to calculate their market shares based on the largest percentage they could claim (via distribution and licensing agreements) or on a wholly-owned repertoire basis. However, increasingly, as they have sought to redefine themselves as content creators, they have chosen sales of owned-repertoire as the prime indication of their performance. The majors' gradual withdrawal from third party distribution and the formation of distribution joint ventures between two or more majors in some territories has added to the new emphasis on wholly-owned repertoire sales.

This is also the way that international record industry association IFPI calculates its market shares. This definition of wholly-owned repertoire market share excludes revenues from third party distribution, licensing revenues and other revenues that record companies receive, such as producers' rights royalties and . The exception to this is the majors' income from record club sales in North America. Although this is licence-based,

The revenues and operating profits of the majors in 2002*

	Revenues ($bn)		Operating profits/(losses) ($m)	
BMG	2.93	(-9)	135	(+271)
EMI	3.54	(-11)	412.7	(+33)
SME	5.30	(+10)	(72.0)	(-147)
UMG	6.79	(-4)	601.0	(-23)
WMG	4.20	(+4)	482.0	(+25)

* Calendar years except for EMI's and SME's, whose fiscal years end on March 31. The figures in brackets are the percentage changes on the previous fiscal year.

Source: Company accounts

The majors: Comparative margins (%)

	EBITDA	EBITA	EBIT
BMG		4.6	
EMI	14.6	12.6	10.7
SME			2.2
UMG			8.9
WMG	11.5		

Source: Company accounts

it is included for market share purposes because of its size. MUSIC & COPYRIGHT calculates that in the US the majors' revenues from this source in 2002 ranged from some $50m for EMI to $200m for UMG.

Record companies' other royalty and licensing revenues streams are not as substantial. Thus, although in 2001 the global revenues from the exploitation of the performance right in sound recordings was over $500m (*see* M&C247/1), the portion that accrued to record companies was much less. Other licence-based revenues include third party deals. For example, WMG has no branch in India and accordingly no market share there, but it will receive some licence revenues from that territory for the sale of its soundcarriers by its licensee. Major record companies also generate revenues by distributing other companies' product.

MUSIC & COPYRIGHT's market shares are based on the trade value of soundcarrier sales, rather than the retail value, because that is what the majors receive. The trade values given for the individual markets are calculated in current US dollars and are for the entire soundcarrier market. Many market shares published by other sources reflect only the combined sales of the member companies of the local affiliate of IFPI. In some countries non-IFPI members have significant market shares, and the shares of companies distributed by the majors are often included as part of the majors' market shares. Accordingly, the market shares of the majors can vary substantially depending on whether the entire market is taken into account or only sales of IFPI members. In some territories a major's wholly-owned repertoire market share is significantly less than its distributor market share. Three examples of this are France, Japan and the US. In France, where there is no sizeable independent distribution company, the combined share of the independents in 2002 was only some 3% in distribution terms, although almost 14% of soundcarriers sold in France last year were released by independent labels (*see table on page13 for details of the French and Japanese markets and the table on page 8 for details of the US distributor shares of the majors*).

As with the previous two years' MUSIC & COPYRIGHT surveys, no chart shares were used in the calculation of the 2002 market shares. Although chart shares show record companies' success with new releases, they take no account of back catalogue and other non-chart releases, which together comprise a significant part of the soundcarrier market.

UMG's market dominance was based largely on its success in the US where UMG was 10 percentage points ahead of its nearest competitor in a market that accounted for 37% of the trade value of the global soundcarrier market in 2002. The prime reason for this was UMG's enormous success in the fast-growing Rap and R&B markets, which in 2002 accounted for 25% ($1,797m) of all soundcarrier sales in the US, compared to 22% in 2001, according to the US record industry association RIAA (*see* M&C 250/1). This can be seen in the table below which details that percentages of the majors' US market shares that came from the sales of Rap and R&B recordings in 2002. The third row of the

US: The majors market shares of the Rap and R&B markets as a protion of their overall market share in 2002

	BMG	EMI	SME	UMG	WMG
All US soundcarrier sales ($m)	834.2	604.0	1,129.0	2,078.2	1,078.7
Total market share	11.6%	8.4%	15.7%	28.9%	15.0%
Rap and R&B sales ($m)	240.0	102.6	242.0	851.0	173.0
Rap and R&B sales as a percentage of sales	28.8%	17.0%	21.4%	40.9%	16.0%

Source: SoundScan, MUSIC & COPYRIGHT research

Continued on page 13 ▶

Authors' society JASRAC reports a 0.7% rise in collections to $887m driven by a 91% growth in MPRT revenues

Japan's authors' society JASRAC, which collects performance and mechanical royalties on audio, video, online and printed music products and services in Japan, has announced its royalty collections rose 0.7% to ¥106.07bn ($886.8m) in the year ended March 31. This increase, coming at a time of falling soundcarrier sales and a depressed economy, was attributable to the near doubling of MPRT royalty collections and higher overseas receipts (*see table on page 7 for details by source of revenues*).

With collections of MPRT royalties rising 91% to ¥7.3bn ($61.2m), Japan remains by far the largest source of such revenues for authors and publishers in the world. This revenue stream will increase even faster, according to analysts, as a new generation of handsets allows users to download original recordings, or cover versions, rather than the simple non-polyphonic ring tones which are currently the most frequently downloaded samples. Other wireless/online royalties were some ¥334m($2.8m), bringing total 'interactive' royalty collections for the year to ¥7.66bn ($64m). Online karaoke royalty collections rose 5.4% to ¥5.59bn ($46.7m), showing the resilience of the sector amid Japan's ongoing recession.

JASRAC's receipts from the performing right rose 2.5% to ¥41.5bn ($347m), boosted by 4.6% higher broadcasting receipts and 25% higher overseas receipts. Although the increase in foreign royalty collections reflected the lower value of the Japanese yen against most major currencies, another factor was the growing popularity of Japanese repertoire in South East Asia. When JASRAC, as is expected, signs a reciprocal agreement with Korean authors' society KOMCA, these foreign revenues should rise further. Domestic general performance royalty collections fell 0.7% to ¥20.7bn ($173.1m).

Mechanical collections were negatively affected by the continuing fall in soundcarrier sales in Japan, which fell 10% in local currency terms in 2002 and 8% in 2001. Figures for the year to date show a further drop of 13% (*see table page 7*). Overall JASRAC's mechanical collections fell 7.4%, led by a 9.4% decline in collections from the sale of CDs. Music video royalties also fell, by 1.3%, confirming that the boom in music DVD sales seen in other markets is not taking place to the same extent in Japan. In 2002, the increase in Music DVD sales, at 27% to 11m units, was the lowest of the Top 10 territories of the world (see M&C 236/4). Foreign mechanical receipts rose fourfold to ¥129.5m ($1.1m), mainly because of the overseas sales of Japanese *anime* (animated films) DVDs.

CD rental has been in decline over the past 10 years in Japan. JASRAC's collections in 2002 fell 3.2%, with a 4.5% decline in audio rental collections to ¥3.5bn ($0.3m), following a decline of 4.8% the previous year. This was partly offset by an 11.3% increase in video rental royalties to ¥355m ($3m).

SoundExchange concludes licensing agreement with non-commercial webcasters so avoiding arbitration

Last week SoundExchange, the royalty collection body set up by US record industry association RIAA, concluded a licensing agreement covering royalty rates and related matters, with non-commercial webcasters. The complex agreement avoids the need for arbitration at CARP, the arbitration board of the US Copyright Office, which was scheduled to start at the end of this month, and means that SoundExchange now has licensing agreements with every Internet, cable and satellite audio broadcaster in place. The deal was reached under the terms of the Small Webcaster Settlement Act (SWSA) and will be effective as soon as it is published by the Copyright Office in the US Federal Register.

The agreement covers the period 1998-2004 and applies to non commercial broadcasters, such as college radio stations, which also webcast their transmissions, and Internet-only webcasters. In order to be covered by the agreement non commercial educational entities (NEEs) must opt in by October 15. Other small non- commercial webcasters must opt in to the agreement 30 days after publication in the Federal Register. Those who do not opt in by that date must pay the statutory rate agreed with small commercial broadcasters in April (*see* M&C 249/15). SoundExchange has proposed extending the non-commercial webcaster statutory rate for 1998-2002 to 2003-2004 and the webcasters have indicated they will not oppose that proposal.

NEEs will pay $200 a year for 1998-1999, rising to $250 until 2003. Thereafter large (over 10,000 students) NEEs will have to pay $500 a year. Other non-commercial webcasters must pay SoundExchange $200 for 1998-1999, $250 for 2000, $300 for 2001 (or $250 if the webcasts comprise only news/talk and sports), $350 for 2002 (or $250 as before), $400 for 2003 (or $250) and $500 for 2004 (or $250).

Non-commercial webcasters transmitting on more than one channel will pay $500 a year, unless they are news/talk/sports (NTS). As of 2004, non commercial webcasters with more than 146,000 aggregate tuning hours of transmission per month (more than 200 average simultaneous listeners) will also pay usage fees of $.0002176 per performance or $0.00251 per aggregate tuning hour, or less ($0.0002 per performance) for NTS channels.

The money SoundExchange receives is distributed to record companies, featured and non-featured performers. SoundExchange plans to make its first 2003 distribution soon.

Verizon agrees to give the RIAA the names of four subscribers alleged to be file-sharing copyrighted works

US-based Internet Service Provider (ISP) Verizon has agreed to hand over the names of four subscribers, who were allegedly offering hundreds of copyrighted songs for file sharing over the Internet, to US record industry association RIAA. Verizon agreed to disclose the names after the US Court of Appeals last week rejected Verizon's request to stay an earlier court ruling. RIAA wants the names in order to sue the four individuals individually for copyright infringement. Verizon argued that the RIAA's subpoena contravened client confidentiality. RIAA argued that clauses in the Digital Millennium Copyright Act (DMCA) backed its stance (*see* M&C 249/2, 237/2).

The decision sets an important precedent. It means that the RIAA, or other copyright owner groups, could obtain the names of alleged file-shares from any ISP they might use. Verizon said it remained concerned that RIAA and other copyright owners 'and people who are not copyright owners' may abuse the process. The telecommunications company noted that recently RIAA had mistakenly sent a cease and desist letter to Pennsylvania State University's astronomy department because the word Usher appeared linked to MP3 on its server. Usher turned out to be the second name of a retired professor, not the recording artist.

Verizon is still challenging two court rulings ordering the company to disclose names to RIAA under a procedural short cut, arguing that such actions could be open to abuse in future, and could lead to names being disclosed without good cause, for example, permitting website owners to obrain ISP subscriber names for marketing purposes. Verizon suggested that Congress address the issue with new legislation.

Verizon said it had informed the four subscribers concerned, adding that one had removed the Kazaa file sharing software from his or her computer. Technology experts say that new programmes currently being developed will mask users' identities, even from their ISP.

Seeking to revive falling sales in the region, EMI, SME and UMG re-organise their Latin American divisions

Three of the major international record companies have taken action to remedy declining sales in Latin America, particularly in the region's second largest market Mexico, which is suffering from exceptionally high levels of music piracy.

SME, which MUSIC & COPYRIGHT calculates was market leader in Mexico with a 19.7% owned-repertoire market share in 2002 and the overall leader in Latin America with a 17.9% share (*see tables on pages 6 and 13*), has created a new sub-region, Sony Music Norte (SMN), encompassing US, Mexico and Central America.

The basis for separating these territories from the rest of Latin America is the genre of music sold there. Mexican and US Mexican regional acts are the main source of repertoire for the US Latin and Mexican markets, and parts of Central America. SMM, which will also comprise Puerto Rico, and the Dominican Republic, will be based in Miami. The president of SME's Latin division, Sony Discos, left the company as part of the restructuring. SME said the creation of SMN completed a reorganization of SME in Latin America following the creation of Sony Music CEV (Colombia, Ecuador, Venezuela), Sony Music Sur (Argentina, Chile, Peru, Bolivia, Uruguay and Paraguay), plus Sony Music Brazil.

According to US-based lobby group the International Intellectual Property Alliance (IIPA), the level of music piracy in Mexico in 2002 was 68%, leading to losses to US copyright holders of $459m. Soundcarrier sales in Mexico fell 19% in peso terms in 2002, according to international record industry association IFPI. In response to this levelk of music piracy, last month the US Trade Representative placed Mexico on its Watch List for the first time since 1999. IIPA also said the 2002 piracy level in Costa Rica was 50%, with losses of $7m and estimated losses in Guatemala were $4.8m. In March the US record industry association RIAA approved $2.5m in extra anti piracy funds for the Latin market for the year ending April 2004. RIAA estimates that 30%-40% of Latin music sold in the US is pirated, while 28% of all piracy seizures in the US comprise Latin repertoire. According to RIAA, shipments of US Latin audio and video product fell 16% in unit terms in 2002.

Separately, EMI, which highlighted problems at its Mexico operations at its recent annual results presentation, announced the retirement of Rafael Gil, the long serving head of its Latin American division. EMI, which had a regional market share of 10.2% in 2002, making it the smallest of the majors there, was also the smallest major in Mexico with an 8.8% share in 2002.

Finally, UMG Latin America announced the creation of the post of Senior Vice President, Strategic Marketing and Operations. The company said the aim of the new posting was to improve efficiencies and streamline its marketing in the region, adding that new distribution and marketing systems should be implemented within the next few years.

MUSIC & COPYRIGHT does not expect BMG or WMG, respectively the third and fourth placed companies in the region, to make similar moves until their protracted merger discussions are concluded either way.

The majors: Global market shares by territory in 2002

Country	Trade value ($m)	BMG	EMI	SME	UMG	WMG	Others
Argentina	51.3	20.0	15.8	16.6	19.5	10.1	18.0
Australia	327.2	8.1	15.0	15.4	24.7	12.9	21.0
Austria	118.9	10.0	16.3	10.0	26.0	11.6	26.1
Belgium	148.0	7.4	17.0	14.3	29.5	8.2	23.6
Brazil	236.0	13.2	9.2	13.2	18.6	12.8	33.0
Canada	439.5	9.5	13.9	16.3	32.1	13.5	14.7
Chile	25.3	11.4	20.2	20.2	18.0	22.4	7.8
Colombia	30.7	0.0	12.8	32.5	21.9	6.7	26.1
Czech Rep.	22.9	11.0	1.1	13.5	26.7	9.4	22.4
Denmark	102.9	8.0	26.3	15.1	25.8	9.7	15.1
Ecuador	5.0	0.0	9.8	44.6	16.2	0.0	29.4
Finland	69.0	10.0	21.1	11.4	19.4	13.7	24.4
France	1,242.2	6.3	18.2	16.7	34.2	10.7	13.9
Germany	1,306.0	14.5	15.1	13.7	25.6	12.9	18.2
Greece	61.8	0.0	26.0	15.1	19.8	6.1	33.0
Hong Kong	74.2	7.1	8.2	12.6	31.5	13.0	27.6
Hungary	29.9	9.3	14.7	9.4	12.5	11.5	42.6
India	123.1	0.0	1.4	6.5	6.5	0.0	85.6
Indonesia	148.4	5.8	5.2	19.3	13.8	9.8	46.1
Italy	357.9	13.0	17.4	14.8	27.2	17.0	10.6
Japan	3,170.9	5.5	10.2	16.5	11.5	5.6	51.1
Korea	149.1	6.5	5.3	8.8	16.8	6.2	56.4
Malaysia	26.2	11.6	15.2	15.0	15.6	17.0	25.6
Mexico	283.2	15.0	8.8	19.7	18.4	15.4	22.7
Netherlands	226.2	9.3	14.1	16.0	24.8	9.2	28.4
New Zealand	55.6	9.1	17.1	18.3	24.8	13.1	17.6
Norway	133.7	6.1	18.1	13.9	24.4	9.5	28.0
Poland	56.3	8.6	16.1	13.1	24.0	12.9	25.3
Portugal	102.1	5.0	19.2	13.4	20.6	7.0	34.8
South Africa	69.1	11.8	26.2	14.5	23.7	0.0	23.8
Spain	363.9	10.6	6.8	10.1	19.3	16.8	36.4
Sweden	174.0	10.0	22.6	14.6	17.7	11.9	23.2
Switzerland	210.6	9.3	16.2	14.4	25.4	11.6	23.1
Taiwan	130.9	7.5	11.0	14.4	13.5	14.0	39.6
Thailand	57.2	6.0	4.1	11.1	8.8	7.3	62.7
UK	1,777.8	9.8	19.1	9.2	28.1	9.8	24.0
US	7191.0	11.6	8.4	15.7	28.9	15.0	20.5
Venezuela	11.6	19.4	10.2	22.2	19.0	8.4	20.8
TOTAL	19,005.6	9.8	12.0	14.8	24.6	11.9	26.9

The zero amounts denote that the company does not have a branch in that territory and receives licence revenues from there.

Source: music & copyright research

The majors: Global market shares 1999–2002 (%)

	BMG	EMI	SM	UMG	WMG	Others
1999	10.1	11.8	17.0	21.7	11.4	28.0
2000	8.4	13.5	14.4	22.9	12.0	28.9
2001	8.2	13.0	14.7	23.5	11.8	28.9
2002	9.8	12.0	14.8	24.6	11.9	26.9

Source: IFPI, MUSIC & COPYRIGHT research

For comment see story on page 1

Soundcarrier shipments in selected territories January–April 2003 (units m)

	Singles		LPs		MCs		CD albums		Trade value ($m)	
Argentina	0.02	n/a			0.19	(+354)	2.6	(+507)	34.3	(+502)
Finland	0.17	(+34)			0.01	(-53)	1.9	(+12)	23.4	(+11)
France	11.01	(-14)	0.14	(+7)	0.68	(-46)	33.0	(-7)	406.6	(-11)
Japan	21.4	(-25)	0.14	(-38)	4.2	(-5)	71.9	(-18)	1,067.3	(-13)
Norway	0.29	(-12)			0.001*	(-52)	3.7	(+3)	39.1	(-0)
US	2.91	(-41)	0.60	(+21)	6.33	(-45)	183.3	(-5)	n/a	n/a

* Includes LPs. The figures in brackets are the percentage changes on the same period in 2002.

Source: National IFPI groups; Nielsen SoundScan

JASRAC: Revenues by source in 2002–2003

	Revenues (¥bn)	Revenues ($m)	% change
General performance	20.73	173.3	(-0.7)
Broadcasting	17.97	150.2	(+4.6)
Overseas	0.54	4.5	(+24.7)
Other	2.28	19.1	(n/a)
Total Performance	41.52	347.1	(+2.5)
Phono-mechanical CD	30.87	258.1	(-9.4)
Phono-mechanical MC	2.26	18.9	(-19.3)
Overseas	0.13	1.1	(+300.3)
Other	11.56	96.7	(n/a)
Total Mechanical	44.82	374.7	(-7.4)
CD Rental	3.48	29.1	(-4.5)
MPRT	7.32	61.2	(+91.2)
Other	8.93	74.7	(n/a)
Total	106.07	886.8	(+0.7)

The percentage changes are calculated in local currency. Figures may not add up due to rounding.

Source: JASRAC

COMMENT: The table above details the deliveries of soundcarriers in Argentina, Finland, France, Japan and Norway as reported by national IFPI groups for the first four months of 2003. Also listed are the Nielsen SoundScan figures for unit sales in the US market.

The large markets of France, Japan and the US all reported significant declines. Taking into account the fact that the value of soundcarrier sales fell 26% in Germany and 13% in the UK in the first three months of the year, this would suggest that the sales decline of 2002 is continuing into 2003 at an accelerated rate.

Trade value of global soundcarrier sales 1998–2002 ($m)

1998	24,524.1	
1999	24,565.1	(+0.17)
2000	23,526.3	(-4.25)
2001	21,129.2	(-10.17)
2002	19,470.6	(-7.85)

The figures in brackets are the percentage changes on the previous year

Source: MUSIC & COPYRIGHT research

For comment see story on page 1

Older consumers and iTunes offer a hope of recovery for the troubled US recorded music market

MUSIC & COPYRIGHT calculates that the retail value of soundcarrier shipments in the US in the first three months of 2003 fell 13.5% in dollar terms compared to the same period in 2002. Sales to retail, excluding direct and special markets, fell 9.9%. Even including DVD music video, the one growth sector of 2002, the declines were 13.3% and 9.8% respectively. This fall in deliveries was reflected in actual sales. According to market research company Nielsen SoundScan, which reports sales at 85% of US retail outlets and projects the rest, soundcarrier sales fell 8.7% in unit terms in first five months of 2003. The sales of MCs fell 44%, singles 36% and CD albums by 6%.

This decline in US soundcarrier sales is also seen in their trade value. There was a 9.4% fall in the trade value of soundcarrier sales, to $7.63bn, in 2002 and a 4.7% fall, to $7.93bn, in 2001. Both the trade and retail value of soundcarrier sales in the US in 2002 (trade $7.63bn; retail $12.33bn) were lower than in 1998 ($8.52bn; $13.20bn). According to a survey by US music retailers' association NARM, the instore sales value of the US music market in 2002 was $8.93bn. The discrepancy is attributable to the difference between list price (as used by record industry association RIAA) and actual price and to the fact that the RIAA includes online, mail order and record club sales in its data. NARM's figures, which show a 15% fall in value in 2002 compared to 1999 (*see table on page 9*), further confirm the general decline in the value of soundcarrier sales in the US.

This decline has been primarily attributed by the RIAA and several record company executives to unauthorised file sharing and CD-copying. While such activities have had an undeniable negative effect on soundcarrier sales, there is also evidence that the US music market is undregoing a process of structural change. This is reflected in this year's *Annual Consumer Survey* released by the RIAA, which showed that the US record buying public is undergoing major shifts in terms of music tastes, age gender and preferred point of purchase (*see* M&C 251/1). It is not clear that the industry has addressed these changes. At a time when older people buying soundcarriers at non-specialist outlets are becoming increasingly important consumers of pre-recorded music, the industry is still largely targeting its marketing spend at younger consumers and specialist chains.

US: Distributor soundcarrier market shares*, 2002 (%)

BMG	14.79	14.71
EMI	8.43	10.64
Caroline	0.87	0.73
EMI TOTAL	9.30	11.37
SME	15.67	15.65
RED/Loud/SMSP	0.81	1.30
SME TOTAL	16.48	16.95
UMG	28.88	26.40
WMG	15.87	15.93
ADA	1.13	0.64
WMG TOTAL	17.0	16.57
Others	13.56	14.16

* Includes music DVDs. The second column of figures are the shares in 2001.
Source: MUSIC & COPYRIGHT research

These changes in the market are conformed by a report last week by research group NPD. It notes that 60% of music consumers with access to the Internet have never downloaded 'free music' from file-sharing websites and concludes that if file-sharing were to end, the soundcarrier market would not necessarily grow automatically. NPD highlights the growing importance of older consumers, but the way in which music is being consumed and the way it is being presented to consumers are also having a significant impact on record companies, particularly in the US where these changes are most visible. The new opportunities for music content creators, such as video games, MPRTs, synchronisation and the online music market, lie mostly outside the traditional route from record company to consumer, via physical soundcarrier sales. Thus, the financial problems of many specialist retailers look set to continue. However, to date the record industry has not found a commercially viable new revenue stream to equal physical sales.

The US remains the biggest soundcarrier market in the world, accounting for 40% of global sales by retail value in 2002, up from 37% in 1999 and 31% in 1997. This growing share of world sales is attributable in part to currency fluctuations, but also because the US market was, until 2002, more resilient than others mature markets, such as Netherlands and Japan. In these mature markets CD sales started to fall earlier than in the US, partly because CD replacement was more rapid than in the US where, as late as 1997, MCs accounted for 19% of album sales (compared to 1.6% in the Netherlands and 2.5% in Japan the same year). CD album sales in the US did not start to fall until after 1999 (when they were flat). In 2002 CD albums accounted for 96% of album sales in unit terms.

The RIAA's detailed breakdown of sales from 1997 to 2001 shows the precipitous decline in sales of CD singles, which fell every year from 1997, falling by a total of by 92% in unit terms and 91% in value terms over the five year period (*see table on page 9*). The MC single format effectively disappeared in 2000 when returns outnumbered shipments. However the vinyl singles market has proved relatively resilient, with unit sales dropping only 19% over the five year period.

The US is also notable for the low sales of foreign-langiuage repertoire. Although the US (Spanish-language) Latin market ac-

US: Shipments of soundcarriers 1997 – 2001 (units m)

	1997	1998		1999		2000		2001	
CD singles (units)	56.0	55.9	(-0)	34.2	(-39)	17.3	(-49)	4.5	(-74)
CD singles (retail value $m)	213.2	222.4	(+4)	142.7	(-36)	79.4	(-44)	19.6	(-75)
MC singles (units)	26.4	14.2	(-46)	1.3	(-91)	-1.5	(-215)	-0.5	(-68)
MC singles (retail value $m)	94.4	48.0	(-49)	4.6	(-90)	-5.3	(-215)	1.6	(-70)
Vinyl singles (units)	5.4	5.3	(-2)	4.8	(-9)	5.5	(+15)	4.4	(-21)
Vinyl singles (retail value $m)	25.7	27.9	(+9)	26.3	(-6)	31.4	(+19)	24.9	(-21)
LPs & EPs (units)	3.4	2.9	(-15)	2.2	(-24)	2.3	(+5)	1.7	(-24)
LPs & EPs (retail value $m)	34.0	31.8	(-6)	27.7	(-13)	27.4	(-1)	20.5	(-25)
MC albums (units)	158.5	123.6	(-22)	76.0	(-39)	45.0	(-41)	31.1	(-31)
MC albums (retail value $m)	1,419.9	1,061.6	(-25)	626.0	(-41)	363.4	(-42)	209.8	(-42)
CD albums (units)	847.0	938.9	(+11)	942.5	(+0)	881.9	(-6)	803.3	(-9)
CD albums (retail value $m)	11,416.0	12,816.3	(+12)	13,214.5	(+3)	12,909.4	(-2)	12,044.1	(-7)
Total audio (units)	1,096.7	1,138.3	(+3.8)	1,057.7	(-7.1)	942.9*	(-10.9)	834.3*	(-11.5)
Total audio (retail value $m)	13,203.2	14,141.7	(+7.1)	13,961.5	(-1.3)	13,221.0*	(-5.3)	12,062.5*	(-8.8)
Total audio (trade value $m)#	7,851.4	8,443.9	(+7.5)	8,325.6	(-1.4)	7,933.3	(-4.7)	7,191.0	(-9.4)

* This includes DVD audio albums: In 2001 7.9m DVD audio albums were shipped at a retail value of $190.7m. In 2001 10.7m DVD audio albums were shipped at a retail value of $273.3m. The figures in brackets are the percentage changes on the previous year.

Source: RIAA, except # music & copyright research

counts for about 4% of US sales, other non-English language sales are almost negligible. According to RIAA, local repertoire accounted for 93% of sales in 2001, international for 5% and classical for 2%. Repertoire from several English-speaking countries, such as Australia and the UK has been regarded as local for these purposes, as have acts from Canada, many of which, such as Avril Lavigne and Céline Dion, are signed to the US branches of their respective companies. Recent studies have shown that US consumers buy much less British music than was the case 10 or 15 years ago. In response to this the UK industry aims to set up a British Music office in New York. The failure of many major UK acts to find sales success in the US is currently exemplified by Robbie Williams. His albums regularly sell some 3m units in the UK but he has yet to have a significant hit in the US, despite heavy marketing and promotion.

According to Nielsen SoundScan, the five majors had a combined album distributor share of 83.6% for the first quarter of 2003, led by UMG, which was the market leader in 2002, with 28.9% (*see table left*). Boosted by several best-selling Rap albums, UMG's share rose from 26.7% to 28.3% in the first quarter of 2003 and its share of current album sales was 30.9% (up from 27.4%), showing the importance of new releases to the company (*see table on page 3 for more details*). UMG is owned by France-based Vivendi Universal (VU). Several bidders, including the previous owner, Edgar Bronfman Jr., have expressed an interest in buying all or part of VU's US entertainment assets. However, this uncertainty does not appear to have had any negative effect on the company's sales. For the week ending May 31, the Top 3 albums on the *Billboard 200* album chart were all released on UMG's Interscope label. Through a series of acquisitions, joint ventures and distribution agreements UMG has also become the largest distributor in the US Latin sector (*see* M&C 243/5). UMG's US Latin distributor share in the first quarter of 2003 was 32.5%, up from 18.8% previously (*see* M&C 249/7).

UMG's five best selling albums in the first five months of 2003 have been 50 Cent's *Get Rich or Die Tryin'* (4.8m units) and four albums released in 2002. These include the *8 Mile* soundtrack 895,000 units, (4.4m since its release); Eminem's *The Eminem Show*, 894,500 units (8.5m since release); Shania Twain's *UP!* 809,000 units (3.7m); and Nelly's *Nellyville*, 787,500 units (5.7m). The company has continued to consolidate its leadership in the first five months of this year. Its January-May album market share was 28.2% (up from 27.4% in the same period of 2002), and its current album share was 30.2%, up from 28.5%. According to Nielsen SoundScan, in the period ending May 25, UMG also had the leading market share in Classical (27.3%), Country (31.8%), R&B (42.6%), Rap (53.9%), Soundtracks (43.6%), Latin (35.1%), Catalogue (24.6%) and Deep Catalogue (24.7%). The only genres where UMG was not ranked first or second in the five month period were Gospel and New Age. However, recent results show that even this degree of dominance in the world's largest soundcarrier market does not guarantee growth or profitability. In the

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first three months of 2003 UMG's sales fell 19% to €1.1bn ($1.27bn) (*see* M&C 251/14).

Although the company started with a low cost base, as the smaller, lightly staffed Universal absorbed the larger PolyGram, analysts say the group now has too large a roster and has fallen behind some of its competitors in terms of cost-cutting initiatives, particularly in the area of distribution. Although UMG only has two manufacturing plants and four distribution centres in the US, it retains 12 US sales offices. However, UMG has consolidated some functions within Universal/Motown and UMG Nashville. Recently the company also decided to outsource payroll and accounts payable functions from its operation in Delray Beach, Florida.

Second placed WMG had a first quarter album market share of 16.5%, down from 16.9% in the same period of 2002. Its share of current albums was smaller at 15.2%, demonstrating the importance of catalogue for WMG. The company's most successful album in the year to date has been Linkin' Park's *Meteora*. The album had the highest first week sales ever recorded by SoundScan, at over 810,000 units, and has sold 2m units to date in the US. Other recent success include Kid Rock's *Cocky*, which has sold 1.5m units, while Sean Paul's *Dutty Rock* has sold almost 1m units in the first five months of 2003. However, Madonna's latest album, *American Life*, has only sold 448,000 units in the US.

WMG's ownership of Word gave it a leading 31.3% share of the stable Christian market, which has not declined as rapidly as the market overall (*see* M&C 244/6). To date WMG has not begun a similar level of restructuring to that inaugurated by BMG completed by EMI and recently begun by SME. However, in late 2002 it made significant changes to its corporate structure and set in motion an ongoing cut costing programme (*see* M&C 242/14). As part of this, the company is close to selling its manufacturing operations for a reported $1bn. This would make it the first of the majors to withdraw from US manufacturing entirely.

SME's stable 15.4% share and 15.1% current album share maintained it in third place in 2002. The company's best-selling albums in the first five months of 2003 have mostly been carryover sales, led by Dixie Chicks' *Home* (1.6m units in 2003, 6.1m units in total), the *Chicago* soundtrack (1.8m; 1.9m), Céline Dion's *One Heart* (2.4m, 2.4m), Jennifer Lopez's *This Is Me...Then* (0.6m, 2.6m) and Good Charlotte's *Lifestyles of the Rich and Famous* (0.8m, 2m). SME also remains a significant distributor in the US Latin sector, with a 21.7% share in the first quarter of this year, down from 23.5% in the same period of 2002. Following the replacement of Thomas D Mottola as head of the US-based SMEI at the start of the year SME has set in process an nextensive restructuring, mainly aimed at improving marketing and distribution functions (*see* M&C 243/2, 250/10).

BMG's 2002 total and current album market shares fell to 13.5% (from 15.7%) and 15.8% (from 18.9%) respectively. Its market shares for the first three months of the year also fell, from 15.7% to 13.5% and from 18.8% to 15.8% respectively. One reason for this is that BMG released fewer new albums in the first quarter of 2003. Its best sellers were mainly carryover hits such as Avril Lavigne's *Let Go*, which has sold 1.4m units this year and Christina Aguilera's *Stripped* (850,000). The company's biggest hit to date in 2003 is R Kelly's *Chocolate Factory* (1.75m). Other successful albums include Evanescence's *Fallen* (1.15m)and Justin Timberlake's *Justified* (890,000). In addition to acquiring successful acts such as R Kelly and Justin Timberlake, BMG's purchase of Zomba has also given it a leading position in the Christian market. Provident/Zomba had a 29% share of the Christian market in 2002.

At the start of the year BMG reorganised its global structure, centralising its management and marketing in the US and prioritised the global marketing of a few successful acts (*see* M&C 244/14). Combined with the purchase of J Records, which brought former Arista head Clive Davis back to run RCA (*see* M&C 240/2), and the purchase of Zomba, this has meant a period of significant disruption for BMG. BMG says that the consolidation of Zomba is now almost complete, but the renewed spate of merger speculation, most recently with WMG, would involve BMG in another bout of restructuring if a merger were to prove successful.

EMI, which in the last 12 months has overhauled its US operations and returned to profitability in North America (*see* M&C 251/5), saw its US market share fall in 2002. However, boosted by continuing sales of albums by Norah Jones and Coldplay in the first three months of 2003 it saw its total US album share rise slightly to 9.8% (from 9.2%) while its current album share rose over one percentage point to 9.4%.

In addition to staff reductions, the integration of Virgin and other cost saving moves, EMI has reorganised its distribution and marketing arm EMD, creating EMM to market EMI acts nationally in the US and improve cooperation between EMI Recorded Music and EMI Music Publishing in synchronisation deals (*see* M&C 248/2). Its best-selling albums in the US in the year to date (with US sales since release in brackets where different) have been Norah Jones *Come Away With Me*, 3.4m (6m), *Now...12*, 1.1m, Coldplay's *A Rush of Blood to the Head*, 0.9m (1.7m), Snoop Dogg's *Paid Tha Cost to be Da Boss* 0.5m (1m), Rolling Stones' *40 Licks*, 0.4m (1.96m) and Lisa Marie's Presley's *To Whom It May Concern*, 0.4m.

The independents, many of which are distributed by the majors or their 'independent' subsidiaries such as WMG's ADA or SME's RED (*see table on page 8*), had an improved overall share in the first three months of the year. However, their combined current album share fell from 14.9% to 13.6% an indication that catalogue is becoming increasingly important in the independent sector. Leading independent companies include Koch, TVT, DreamWorks SKG, which has so far failed to replicate the success of its co- founder's Geffen label, Curb, Tommy Boy, Wind-Up and Disney's Hollywood label. None of these has a market share of more than 1%.

In 2002 many music retailers offset weak soundcarrier sales with higher sales of music DVDs. According to the RIAA, music DVD sales rose 35% in 2002 while music VHS sales were down 64%. A breakdown of NARM members' sales by product category shows the growing importance of video and non-music prod-

uct to specialist music shops. In 1999 music accounted for 38% of NARM members' sales, this had fallen to 30% by 2002 (*see table below*). Video's share of sales rose from 7.5% to 11.4% in the same period. NARM's survey also found that 87% of its members reported lower sales in 2002. In response to these lower sales and falling margins many specialist retailers and independent distributors ceased trading or moved close to bankruptcy in 2002. Independent distributor Universal One Stop ceased trading last month, and Valley went out of business last year. During the same period Handleman has struggled as mass retailer and Kmart, which accounted for 35% of its business, has been in bankruptcy proceedings, closing 600 of its 2,100 outlets. Electronic retailer Brest Buy has said it wants to sell loss making Musicland which it bought in 2002.

The revenues of US music retailers by source, 1999 and 2002 compared ($bn)

	1999	2002	% change
Music	10.49	8.93	-15
Video	2.04	3.36	+65
Related products	14.77	17.14	+16
TOTAL	27.30	29.43	+8

Source: NARM

UK-based chain VEG, which previously employed buyers for each outlet, in order to reflect local tastes, has responded to the changing market by centralising buying. Despite having debts of over $100m, Trans World Entertainment (TWE) has invested $40m installing kiosks which allow consumers to access 30 second audio and video clips of over 300,000 titles. At the same time this year US retailers have had to change their accounting procedures. This has negatively affected the results of many chains. For example, Hastings Entertainment recently announced first quarter losses of $1.1m, almost half of which was attributable to the accounting changes. Similarly a small profit for TWE was turned into a loss by the change (*see* M&C 251/15). Last week two more large chains announced cutbacks and financial problems. Wherehouse, which is seeking to emerge from Chapter 11 bankruptcy protection, announced the closure of 30 more stores, leaving it with 145 outlets. Separately Tower defaulted on an interest payment of $5.2m, having already taken advantage of a 30 day grace period. The chain, which has sold its Japanese and UK stores, is aiming to restructure its $110m debts.

The US media sector is becoming increasingly consolidated. This process looks set to intensify. Last week the Federal Communications Commission (FCC) approved changes that would relax controls on media ownership in the US. Opposed by lobby groups such as the Future of Music Coalition (FMC), the loosening of restrictions will allow one company to own several media outlets, for example a newspaper and a television station, in most towns and cities. The change is widely predicted to result in a few large companies, such as Clear Channel Corp (CCC) and News Corp, owning more media outlets in the US's key markets. An FMC report argues that CCC's ownership of the biggest radio stations in large cities has led to less variety of music being played on radio. It has also been alleged that CCC unfairly publicises concerts it is promoting locally with increased radio airplay of the featured acts. However, in April CCC said it would no longer accept payment from independent radio promoters. This practice, which was widely believed to constitute a disguised form of paying radio stations to play specified records, had drawn increasing criticism in the US.

As well as being the largest broadcaster in the US, CCC is the largest live music promoter and venue owner. The live sector boomed in 2002, with ticket receipts rising 20%, according to US trade publication *Pollstar* (*see* M&C 243/4). The increase was partly attributable to higher prices, but also to tours by several superstar artists, notably Paul McCartney. The average price of a ticket for the Top 100 tours rose 6% to $46.56 in 2002. This masked a very wide divergence between prices. For example, the average price for a McCartney ticket was $130 compared with $40 for the Dave Matthews Band.

The success of the Apple iTunes download shop, which sold almost 4m tracks in its first month of operation, suggests that many consumers are willing to pay $1 per track if the interface is quick and easy to use, and if there are few limits placed on the copying and portability of downloads (*see* M&C 250/5). Early indications are that the service is attracting older consumers who are downloading entire albums. However, despite the initial success of iTunes, it will be the plannned Windows version of the service that will comprehensively demonstrate the viability of downloading online music services. At present, in view of the greater security threats that such a service inevitably entails – there are more Windows hackers than Apple ones – at least two majors are unwilling to licence their repertoire to a Windows version of iTunes. Already iTunes has had to restrict the file-sharing capabilities of its service.

Competitors reacted swiftly to Apple's success. RealNetworks, the main developer of and investor in the B2B platform MusicNet, announced it would stop distributing MusicNet and will instead offer its subscribers Rhapsody, which was developed by Listen.com and which it bought last month. In addition RealNetworks has cut the price of downloads to 79 cents each. This leaves AOL, which through WMG is an investor in MusicNet, as the only company using MusicNet as the platform for its online music sales. Another competitor will be Roxio, the owner of the Napster brand, which bought Pressplay from SME and UMG, and intends to use it as the basis of a re-launched Napster download service (*see* M&C 251/4). Separately the main US retailers have created the Echo online joint venture although there have been no reports of the venture's progress so far. And Wal-Mart's music distribution company Anderson Merchandisers bought online pioneer Liquid Audio for $3.2m (*see* M&C 244/1).

With the sale of the Trio and Quartet catalogues to Windswept (*see* M&C 250/1) there are few classic catalogues left for larger publishing companies to buy in the US. Also during the year EMI consolidated its ownership of the Jobete catalogue of Motown hits, paying $135m to bring its stake in the company to 80%. EMI Music Publishing (EMI MP) has also tabled a bid for the UK-

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US

based Boosey & Hawkes catalogue (*see* M&C 250/15). One reason that the major record company owned publishers have been unwilling to bid for independent publishers is the high multiples being sought by catalogue owners at a time when mechanical revenues are falling.

Although they have been broadening their sources of revenue, most notably from video games and synchronisation, the decline in soundcarrier sales has had a negative impact on US publishers' revenues. MUSIC & COPYRIGHT estimated that the Gross Retained Revenues (GRR) of US publishers fell 14% in 2002 to $1.2bn (*see* M&C243/1). The largest publishing company in the US (and worldwide) is EMI MP with an estimated North American share of 21%, followed by Warner Chappell with 18% and Universal Music Publishing Group (UMPG) with 10%. Independent publishers, led by mid sized companies such as Carlin, Chrysalis, Famous and peermusic, had a combined 38.5% share in 2002 and revenues of $462m.

Recent synchronisation successes for EMI MP include *Start Me Up* (Ford Motors), *My City Was Gone* (Rush Limbaugh programme) and *You Make Me So Very Happy* (American Express), while the company has 28 copyrights featured in the video game *Grand Theft Auto* which has sold over 8m copies worldwide. Recent US signings include Norah Jones, Jewel and Ricky Martin.

Like EMI MP, Warner Chappell is less dependent on mechanical revenues than most of its competitors. Whereas BMG MP, Sony/ATV, and UMPG derive between 56% and 61% of their North American GRR from soundcarrier sales, mechanical royalties account for only 52% of Warner Chappell's North American revenues. Recent Warner Chappell US successes linked to soundcarrier sales include writers Andreas Carlsson and Kristin, who have written songs for Céline Dion, Bon Jovi and Leann Rimes; R&B/Urban writers Dr Dre, Shaggy and John Shanks; and country writers Holly Lamarr and Marv Green.

Third placed UMPG has consolidated its success with Rap recording artists by signing 50 Cent and his producer-co-manager Sha Money XL to a worldwide publishing deal. It has also recently concluded worldwide deals to administer the Heart and Lovemongers catalogues, which feature works such as *Crazy On You*, recorded and written by sisters Ann and Nancy Wilson of rock band Heart, and the catalogue of alternative rock band Stone Temple Pilots, which includes the band's No 11 album *Purple*.

BMG Music Publishing (BMG MP) has grown significantly through the acquisition of Zomba. The acquisition will increase its relatively small share of the US market as 78% of Zomba's publishing revenues derived from the US. Some 60% of BMG MP's revenues derive from mechanicals compared to 78% of Zomba's. Recent successes include tracks written and/or performed by Nelly, Christina Aguilera, Linkin' Park and Justin Timberlake, while recent BMG MP signings include producer Chad Hugo of The Neptunes (who has produced recordings by Blink 182, No Doubt, Nelly, Justin Timberlake and Britney Spears), producers The Matrix (who have produced recordings by Avril Lavigne and Britney Spears) and Christina Aguilera and Ben Folds. Recent Zomba signings include producer Ron Feemster (Eminem, 50 Cent), a joint venture with Fred Durst of Limp Bizkit and the extension of long-term publishing deals with Korn, Nas and Justin Timberlake. Last week BMG MP announced the formation of the BMG Film and Television Music Division, which will license BMG and Zomba's record and publishing catalogues for synchronisation purposes. Currently 15% of BMG MP revenues and 9% of Zomba's derive from this sector.

US: Music related royalty collections 2001-2002 ($m)

ASCAP*	635.0	(-2)
BMI#	574.2	(+6.2)
Harry Fox#	454.3	(-20.7)
Total	1,663.5	(-5.6)

* Year ending December 31 2002. # Year ending June 31 2002

Source: Company accounts

MPRTs are still a very limited market in the US, but this could soon be a significant new revenue stream. According to a report published by Informa Media Group, which also publishes MUSIC & COPYRIGHT, ASCAP and BMI collected some $3.8m from MPRTs in 2001. However, this compares with $26.4m by JASRAC in Japan and $4m by KOMCA in Korea (*see* M&C 243/3, 244/6).

The downturn in sales and the high value of the US dollar in 2002 has had a negative impact on royalty collections in the US. Harry Fox (HFA), which collects mechanical royalties for its publisher owners, has yet to announce its 2002–2003 collection. However, these are widely expected to show a decrease on HFA's collections in 2001–2002, which fell by 20.7% to $454.3m (*see table above*), ASCAP announced a 2% decline for 2002 to $635m (*see* M&C 251/12). However, BMI, which collected $547.2m in 2001-2002, a rise of 6%, is expected to announce a small rise in collections for the year ending June 30. Moreover, in view of the resurgence of broadcast advertising revenues in the US, it seems likely that performance royalties will return to growth in 2003.

Although piracy levels are very low in the US, the large size of the market disguises the large losses to copyright owners from organised CD copying. As in other markets the advent of cheap fast CD burners has led to increased sales of illegal CDs. Pirate CDs, both counterfeit and hit compilations, are widely available on streets in the US's main cities for less than $5.Last year they started to appear at small stores (*see* M&C 242/2). In the first 11 months of 2002 the number of piracy raids rose 27% to 612 and arrests rose 37% to over 4,500. Moreover, because of high rates of PC ownership and the wide availability of fast Internet connections, American consumers are among the heaviest users of unauthorised P2P services. They also make copies of CDs for friends and family. However, a recent study by Ipsos Insight found that although half of all teenagers and 20% of consumers aged 12-plus (équivalent to 61m people) have downloaded music from unauthorised websites, 19% would be prepared to pay for downloads. This figure rose to 38% when a scenario of no available P2P services was offered. In contrast, only 8% and 14% respectively were willing to pay for a subscription service.

continued from page 3

Market shares

table lists the value of each of the major's sales of Rap and R&B recordings by aggregating the SoundScan market shares of the majors in both genres, while the third row translates that into a percentage of each of the majors' total soundcarrier sales in the US. The most notable feature to emerge from this analysis is that UMG derived a high proportion of its overall market share from its success with Rap and R&B (41%). This is a considerably higher percentage than the 25% of all soundcarrier sales in the US that the two genres represented overall in 2002. In contrast, EMI (17%), SME (21.4%) and WMG (16%) all derived a smaller percentage of their revenues from sales of Rap and R&B than the 25% it accounted for of the US market overall. The only other major that derived more than 25% of its annual US revenues from the sales of Rap and R&B was BMG at 29%.

In the past, some popular American music genres, notably Country, have not sold well overseas. Until the late 1990s this was also true of Rap and (to a lesser extent) R&B. However, in 2002 most of UMG's big hits in these genres were global successes, most notably Eminem and Nelly. UMG's US market share of rap albums in 2002 was almost 42%, and in the first five months of this year its share rose to nearly 54%. Although the rap world is notoriously divisive and combative, with several high profile artist killings directly linked to competition between rap labels, UMG, through its Interscope and Def Jam label groups, has developed a rapport with established and emerging Rap acts similar that that held by Warner Brothers with rock acts in the 1970s.

At the same time UMG has managed to reposition country act Shania Twain as a pop act outside the US and duplicate her US success. In contrast, SME has been unable to do the same with the Dixie Chicks, a more countrified act and a more successful one within the US. Of all the majors, UMG has been the most successful at marketing new talent. In response, the other majors have sought to restructure their marketing department to operate more efficiently at a global level to enable them to better sell titles by key acts around the world.

Although UMG was heavily reliant on US repertoire in 2002 for its success, its market dominance was widespread. It was the market leader in 23 of the 38 markets surveyed in 2002, including eight of the Top 10 markets of the world (US, UK, Germany, France, Canada, Spain, Italy and Australia). (*See table on page 6 for country by country details and* M&C 230/13 *for full details of 2001 market shares*). With the exception of Latin America, where SME retained its market leadership with a 17.9% share in 2002, UMG was the market leader in all the regions of the world (*see table below*). In most regions the gap between UMG and the second-placed major was sizeable; for example, it had a lead of over 10 percentage points in Europe. As a result despite the size of UMG's success in the US, US sales accounted for only 44% of its revenues.

This survey also shows that the combined share of the world's independent record companies fell from 28.9% in 2001 to 26.9% in 2002. The five majors had a combined global market share of 73.1% in 2002, up from 71.1% in 2001. This will rise again in 2003 when Zomba's share is included in BMG's and when several smaller acquisitions of independent labels by the majors in 2002 are included in their market shares. As in 2001, the independents' combined market shares were slightly above 20% in most regions. In Europe the independents had a combined share of 21.1%, 20.5% in Australasia, 20.2% in North America and 28.5% in Latin America. The exception was Asia where the independents had a combined market share of 46.4%, reflecting the continued success of local companies in most of the region's markets, and limited market access for the majors.

Distributor and wholly owned repertoire in France and Japan in 2002 (%)

	France		Japan	
BMG	8.4	(6.3)	6.8	(5.5)
EMI	19.1	(18.2)	11.6	(10.2)
SME	22.5	(16.7)	17.4	(16.5)
UMG	35.5	(34.2)	13.9	(11.5)
WMG	11.2	(10.7)	7.1	(5.6)
Others	3.3	(13.9)	43.2	(50.7)

The figures in brackets are the wholly owned repertoire market shares in 2002.

Source: music & copyright research

The majors: Regional market shares in 2002

	BMG		EMI		SME		UMG		WMG	
Australasia	8.3	(7.5)	15.3	(16.0)	15.8	(16.9)	24.7	(23.1)	12.9	(12.5)
Europe	9.9	(8.9)	17.2	(17.8)	13.0	(13.3)	27.3	(26.5)	11.5	(11.4)
Latin America	13.9	(10.0)	10.2	(13.1)	17.9	(20.0)	15.9	(15.0)	13.6	(14.5)
North America	11.5	(9.2)	8.7	(10.1)	15.7	(14.4)	29.0	(28.3)	14.9	(14.3)
Asia (ex Japan)	7.0	(6.6)	7.7	(8.6)	12.5	(11.9)	16.2	(16.1)	10.5	(10.5)

The figures in brackets are the market shares in 2001.

Source: music & copyright research; IFPI (2001 figures)

Tracking

Record industry

JAMAICA'S RECORD INDUSTRY has established the Recording Industry Association of Jamaica (RIAJam). Membership is open to registered companies involved in music production, recording studio operations, music publishing, music video production, music distribution and soundcarrier manufacturing. RIAJam plans apply for affiliation with both the US record industry association RIAA and international record industry association IFPI.

THE COLOMBIAN record industry association ASINCOL has reduced the number of sales needed for gold and platinum certifications, because of declining sales in that market. In future albums will be certified gold at 10,000 units (down from 15,000) and platinum at 20,000, down from 30,000.

JAPANESE INDEPENDENT Columbia Music Entertainment last month announced operating profits of ¥22m ($0.2m) on 9% lower sales of ¥29.9bn ($250m), compared with an operating los of ¥1.9bn ($15.9m). However, net losses were ¥1.2bn ($1.7m) because of restructuring costs, down from ¥21.5bn ($179.8m) the previous year. The company, a majority share of which was sold to US investment company Ripplewood in late 2001, is now managed by former BMG CEO Strauss Zelnick.

ACCORDING TO IFPI AUSTRIA, the while sales of domestic repertoire accounted for 11% of the market, the same as in 2001, the sales of 24m blank CD-Rs were higher in 2002 than the sales of pre-recorded CD albums.

BMG GERMANY/ SWITZERLAND/AUSTRIA president Thomas Stein reported that unit sales in Germany fell 26% in the first three months of 2003.

WMG HAS ENTERED has agreed to supply content to Finnish mobile phone manufacturer Nokia. WMG will provide song clips, MPRTs, multimedia message templates and wallpaper graphics to users of the new Nokia 3300 mobile phone. The handset allows users to play MP3 and AAC music files.

EMI HAS SIGNED a deal with Greek distribution agency Argos to sell CDs at street kiosks. The deal is part opf an attempt by EMI to reach remote areas of the mainland and Greek islands where there are no record shops. Minos-EMI launched the project with seven releases by major domestic artists including George Dalaras, Marinella and Yiannis Parios. Last month EMI signed a standard distribution deal for the territory with book distributor Ermis (*see* M&C 250/14).

BMG HAS COMPLETED the integration of Zomba into BMG in the Benelux (Belgium, Netherlands, Luxembourg) region. BMG Benelux managing director Rob Schouw will now oversee the operations of Zomba in the region.

WARNER MUSIC GERMANY is testing a vendor-managed inventory system at two stores operated by entertainment retailer Saturn. The system orders product based on customer response rather than using company staff reports. Under the previous system rates of return were around 40%, sometimes rising to 50%.

US INDEPENDENT ARTEMIS has agreed a US distribution deal with Koch. The label was previously distributed in the US by SME subsidiary RED.

Legal

CALIFORNIA BILL NO 1046, which makes accurate royalty calculation a fiduciary duty for record companies (*see* M&C 251/3) was passed by the California Senate at the end of last month. The bill must now be approved by the State Assembly.

THE EUROPEAN PARLIAMENT last week adopted a *Declaration on the Fight against Piracy and Counterfeiting in the Enlarged EU.* The *Declaration* notes that counterfeiting and piracy leads to an average loss of 17,000 jobs a year in the EU and also lost tax revenue for governments. It also acknowledges that organised crime networks use profits from piracy to finance other crimes such as drug trafficking. According to the European Commission, seizures of pirate optical discs (CDs, DVDs, CD-Roms) have risen by 15,300% since 1999. Pirate CDs account for nearly half the EU's estimated €2bn ($2.4bn) pirate and counterfeiting business. For the *Declaration* to be adopted by the Parliament, it had to be signed by a majority of the 623 Euro MPs within a period of three months. This target was achieved, ahead of the June 26th deadline. The *Declaration* is only the fifth such to be adopted by the current Parliament which was elected in 1999.

UMG LABEL GROUP Island Def Jam and its CEO Lyor Cohen have failed in their attempt to overturn a jury award of $132m damages in favour of TVT records (*see* M&C 250/15). Cohen is personally liable for $56m of the claim. Cohen's lawyer said they would appeal the ruling.

WMG HAS WARNED employees that they could lose their jobs if illegal P2P networks, such as Kazaa, Morpheus, Gnutella or Limewire, are found on their computers. The memo notes that WMG will regularly scan its computer networks 'to detect the presence of file-sharing software on company computers'.

EMI FILED A LAWSUIT against Bertelsmann in New York last week alleging that the German media company infringed copyrights by investing in unauthorised P2P service Napster thus allowing it to continue operating. EMI also filed suit against venture capital firm Hummer Winblad, which also invested in Napster. UMG filed similar lawsuits last

month (*see* M&C 251/15). In February a group of US songwriters and publishers filed a class action lawsuit against Bertelsmann on the same grounds.

US RECORD INDUSTRY ASSOCIATION RIAA is suing the creators of the Morpheus file-sharing network for a second time for unauthorised storage on a central server of thousands of copyrighted tracks fro an Internetradio station it never set up. The new lawsuit comes a month after a judge ruled that Streamcast Networks which developed the Morpheus and Grockster P2P programmes, was not liable for copyright infringement (*see* M&C 249/2).

GLOBAL SOFTWARE PIRACY LEVELS fell to 39% in 2002, from 40% in 2001, according to the US-based lobby group the Business Software Alliance (BSA). The BSA also found that between 1994 and 2002, software piracy rates dropped from 32% to 24% in North America, and from 52% to 35% in Western Europe. However, it also estimated that Russia, Ukraine, China and Vietnam had software piracy rates of 90% or more.

THE FRENCH CONSUMER BODY Union Fédérale des Consommateurs (UFC) has begun legal proceedings against three major international record companies, BMG, EMI and WMG. UFC alleges that the majors' use of copy protection systems on CD albums released in France CDs is illegal. UFC is also taking action against French retailers, FNAC and Auchan. In a filing to a Paris court, UFC argued that France's 1994 copyright law establishes the right for users to make home copies of recorded music and that copy-protected CDs infringe consumers' rights.

Broadcasting

US REGULATORS last week approved wide ranging changes to media ownership rules. The five-member committee of the Federal Communications Commission (FCC) voted three to two in favour of the new regime along Republican-Democrat party lines. As a result television networks such as Fox, CBS and NBC will be permitted to reach 45% of the national audience, rather than the current 35%. The FCC also voted to lift a ban on companies owning both a newspaper and a television or radio station in most cities. Also broadcasters will be allowed to own up to three television stations in the largest US regional media markets instead of the current two. The Chairman of thre Senate Commerce Committee has scheduled a vote on the bill later this month that could revoke the expanded television ownership rules. Radio ownership rules were largely unaffected by the changes. At a June 4 hearing the Commerce Committee noted that FCC officials held 34 meetings with lobbyists representing large media companies, but only one public comment meeting. The FCC received 750,000 comments from citizens opposingthe proposed changes.

MTV NETWORKS (MTVNE) Europe has acquired a 50% stake in French videogames channel Game One for an undisclosed sum through a partnership with French media company Atari. MTVN said that the deal, which marks its first venture in the video game sector, represents the next step in the company's international expansion. Game One is a 24 hour local language channel. It reaches 3.5m homes on all cable and satellite platforms in France.

Music publishing

BETWEEN 10M AND 20M RING TONES (MPRTs) are downloaded each month in South East Asia, excluding South Korea and Japan, according to research by digital music company Soundbuzz. Separately MPRT company Moviso estimates that Japanese consumers download 80m MPRTs per month compared with 60m in Europe. Lastly CNET Asia estimated that 65% of companies that offer MPRTs do not have a licence and are not paying music publishers for the use of their copyrights.

UNIVERSAL MUSIC PUBLISHING GROUP UK (UMPG UK) has signed publishing agreements for the world with London Rap collective Big Brovaz, via the group's manager's Jonathan Shalits's Shalit Music, and with Australian singer-songwriter Butterfly Boucher, who is signed to UMG's Interscope Records. Separately, UMPG has also extended its deals with the Flaming Lips for the world excluding North America and with members of The Clash.

Internet

US-BASED Internet music technology company RealNetworks will offer its subscribers online music downloads via its newly acquired Listen.com Rhapsody music service and will phase out its use of the MusicNet platform. RealNetworks developed MusicNet and owns a 40% stake in the service, which is now used only by AOL. The four shareholders in MusicNet (RealNetworks, BMG, EMI, WMG) recently committed $10m in new funding to the struggling platform. However, last month the company cut 30 staff. Separately Listen.com, which was founded as a subscription service provider, said it was cutting the price of its downloads to $0.79 cents per track. Listen.com, which has not yet been formally acquired by Real Networks for $36m, is the only independent online music service with licensing agreements with all five majors. In March, when it offered Lycos users tracks for $0.49 each, download activity rose over 300% during the trial.

UNAUTHORISED P2P SERVICE KAZAA is to offer its users concert tickets, DVDs and laptops to encourage them to swap legal files. The Peer Points Manager programme is similar in design to frequent flyer miles. Kazaa users will earn points for making legal files available to others

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CANADIAN ONLINE music distribution company, Moontaxi Media is to launch an online music service in September. The service, PureTracks, will use Microsoft Windows Media software.

US-BASED CenterSpan Communications, the owner of the file-sharing network Scour, is to cease operations. The company, which reported revenues of less than $7,000 in the three months to March 31 and had been planning to launch a legitimate music file-sharing service, owes SME $1.25m.

UK-BASED e-tailer the Recordstore, which operates online shops for over 200 UK bands and labels including Robbie Williams, Craig David, Moby, and Ministry of Sound, has been appointed official UK e-commerce partner to UMG and Sanctuary and will also launch etail websites for SME. Sales from these artist websites will count towards chart positions. Recordstore is one of only six e-tailers whose sales are counted as part of establishing the rankings of the UK Charts, which is overseen by UK record industry association BPI.

THE VALUE OF ONLINE RETAIL SALES in the US was $76bn in 2002 and is predicted to reach $96bn this year, according to a survey by Shop.org and Forrester Research. The survey also found that 36.5m US households made purchases over the Internet in 2002. Online sales accounted for 3.6% of all retail sales and are predicted to rise to 4.5% in 2003. The report also predicts that 7% of all music and video sales in the US will take place this year and that online sales of these products will reach $3bn this year, an increase of 27% from 2002.

Retail

US INDEPENDENT DISTRIBUTOR Universal One Stop, which filed for Chapter 11 bankruptcy protection in April, has announced it is to cease trading after 48 years. The company said refusal by UMG to offer it product on special terms agreed by the other four majors made it impossible for it to continue trading.

US-BASED ENTERTAINMENT RETAILER Hastings Entertainment, which has 146 outlets, has reported that sales for the first quarter ending April 30 rose 3.5% to $116.8m, but said that losses were $1.1m, compared with a profit of $569,000 in the same period last year. Hastings said $0.5m of the losses were attributable to changes to accounting regulations regarding vendor considerations. Same store music sales fell almost 12% year on year. This was offset by a 9.5% increase in video rental revenues and a 56% increase in DVD sales.

US-BASED ENTERTAINMENT RETAIL CHAIN Trans World Entertainment (TWE) plans to place listening and viewing kiosks in all its 900 or so stores by the end of this year. According to TWE, sales have risen 20% in the year ro date at the 40 outlets where the kiosks have been on trial.

UK INDEPENDENT MUSIC RETAIL chain Andy's Records, which comprises 23 stores and was once the country's largest independent chain with 40 shops, has gone into administration. Established in 1975 as a market stall in Cambridge. Andy's Records' annual sales were £29m and accounted for 2% of the UK recorded music market at its trading peak in 1998.

Consumer electronics

ACCORDING TO A REPORT by research group Gartner, 112.7m mobile phones were sold worldwide in the first three months of 2003, 18% more than in the same period in 2002. According to the report, Nokia is the market leader with a 35% share. followed by Motorola (14.7%), Samsung (10.5%), Siemens (7.6%) and Sony Ericsson (4.8%).

All dollar figures are US dollars and all historical currency conversions in both text and tables are calculated at the average US dollar exchange rate published by the IMF for the year in question. Where relevant, MUSIC & COPYRIGHT publishes both local currency and US dollar values and shows the percentage changes in both in order to give a better sense of the performance of a company or soundcarrier market. All US dollar conversions in this issue, except where noted otherwise, are at close of business on May 30 2003.

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Off-Key: The Music Industry Is Finally Online, But Few Listen --- Big Labels Counter Napster With MusicNet -- Offering Little and Charging for It --- Now, a Focus on a 2.0 Version

By By Anna Wilde Mathews, Martin Peers and Nick Wingfield, The Wall Street Journal, 2908 words
May 7, 2002

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Early last December, three of the world's biggest music companies launched a counterattack against the rampant digital piracy that has gnawed at their sales in recent years. It was called MusicNet, a joint venture that would provide consumers with a legal alternative to Napster Inc. and other freewheeling Internet song-swapping services.

Within a couple of weeks, the results were clear. As MusicNet Chief Executive Alan McGlade told the venture's board: "The current version of the service is not viable."

It isn't hard to see why. MusicNet's main owners -- AOL Time Warner Inc., EMI Group PLC and Bertelsmann AG, along with fourth partner RealNetworks Inc., a Seattle software company -- created a service that lacked just about everything that makes online music downloads appealing. It didn't allow consumers to keep downloaded songs permanently. It didn't allow them to transfer songs to portable devices or exchange them with friends who weren't signed up to the service. And it charged a monthly fee. Renegade Internet services allow all that and more, for no charge.

Since the launch, MusicNet has attracted only about 40,000 subscribers. Critics have panned it. AOL Time Warner's America Online service, which was supposed to be MusicNet's biggest distributor, says it wants something better before it will introduce the service. MusicNet plans soon to offer about 100,000 music tracks, but it still has enormous gaps in its collection -- most notably, all the artists whose work is controlled by the two biggest recording companies, Sony Corp. and Vivendi Universal SA. They have created their own struggling online venture, called pressplay.

So now, as free sites continue to attract millions of users and before most of the public has even heard of MusicNet, its backers are trying to fix it. "The first offering was too clunky and too consumer unfriendly to hold much hope for its success," says Richard Parsons, AOL Time Warner's incoming chief executive. "So we are going to go back, and we will come out with a 2.0 product which will be more consumer friendly, easy to use. . . . This is a business of trial and error."

Mr. McGlade, MusicNet's CEO, is in advanced negotiations with the companies involved, trying to persuade them to allow the kind of features that consumers want. "You couldn't keep it static and say this is fine," he says. "It's certainly a beginning. We're going to be able to significantly advance the ball in the next year."

But getting it right the second time may not be easy since the program still faces the same problems that dogged it the first time. There is the tension among MusicNet's backers, rivals in other areas whose agendas often don't mesh. There are persistent antitrust concerns, including a continuing Justice Department investigation of record labels' online ventures, which complicate discussions among MusicNet's owners. And there are the problematic relationships between the record companies and the rest of the music industry, which make it difficult for MusicNet to offer as much music as the illegal services do.

The upshot is that, even with the future of their industry at stake, the companies that own recorded music are still unable to fully exploit that trove online. Global sales of compact-disc recordings fell 5.1% last year from a year earlier, the first drop since the format was launched in 1983. The industry blamed the fall largely on the proliferation of homemade CD compilations, as well as free offerings online.

It's a problem not just for the music business, but for the entire entertainment industry, which is trying to figure out

online business models for movies and TV shows at a time when these things, too, are increasingly being swapped on the Internet. Just last month, Hollywood got a lesson in how difficult it will be to harness digital distribution when News Corp.'s 20th Century Fox withdrew from a planned video-on-demand venture with Walt Disney Co. That came as the Justice Department's antitrust division is investigating all the major studios' efforts to deliver their films to consumers via the Internet and digital cable-TV.

The struggle to create a legitimate commercial online music service goes back years, before there even was a Napster. RealNetworks, which develops multimedia software, first began talking about it in 1995 with executives at MCA Music, now owned by Vivendi Universal SA. But Rob Glaser, RealNetworks' fast-talking chief executive, was too early: The Internet was still a new medium with uncertain commercial potential.

Then, a little more than two years ago, the company launched a secret initiative, dubbed "Project Havana." Mr. Glaser, a music buff who got Pearl Jam's Eddie Vedder to play at his 40th birthday party, wanted to build a service that would allow consumers to download songs using Real software. Before that could happen, he would have to secure licensing agreements with each of the major music labels in order to use their songs.

In March 2000, RealNetworks struck its first deal, with Time Warner Inc.'s Warner Music Group. Time Warner would get a stake in the new venture. The executives involved hoisted glasses of Moet & Chandon champagne to celebrate what seemed like a painless entry into the world of digital music.

Mr. Glaser spent months wooing top executives at other record companies. Yet the industry still feared that creating a legitimate market for music downloads would cut into sales of compact discs. "Established businesses find it very difficult to embrace disruptive technologies that threaten them. The music industry is no different," says Paul Vidich, an executive vice president for Warner Music.

But now, music fans were racing to outlaws such as Napster. Teenager Shawn Fanning introduced Napster to the Internet in 1999 as a free software program that let users share digital song libraries on their computers. The program, maintained by Napster Inc., Redwood City, Calif., quickly became the most popular and convenient way to exchange music over the Internet.

By the fall of 2000, Napster had about 38 million devotees, and the music industry was scared. To stop the free-for-all, the major labels sued to shut down Napster. Then, in October that year, Bertelsmann broke ranks and formed an alliance with Napster, agreeing to lend money to the service and to help it develop a legitimate membership service.

Growing congressional interest in online music prodded the industry onward. Lawmakers were eager to see legitimate online music services. For one thing, they were hearing from Internet companies frustrated by the record labels' slow pace licensing their catalogs. And they were also hearing from constituents who were agitating on behalf of Napster. Also, in February, a federal appeals court in San Francisco upheld a lower-court ruling that ordered Napster to dramatically curb its file-sharing service, raising optimism about the prospects for a commercial online music service that would be friendlier to copyright holders.

"We saw an intensification of interest on the part of the music companies to go beyond what they had done before, which were trials and promotions, to really do something deep and serious," Mr. Glaser said later.

By early 2001, Bertelsmann and EMI were deep in discussions to join MusicNet, Bertelsmann hoping that MusicNet would act as a conduit for licensing music to Napster. Warner Music and RealNetworks had dropped the idea of simply selling song downloads. Instead, they focused on creating a subscription service in which users would pay a set fee for unlimited access to all the music they wanted, but on a temporary basis.

Weeks of negotiations on the shape of the venture reached a crisis point on Friday, March 30. The Senate Judiciary Committee had scheduled a hearing on online music for the following Tuesday. The record companies feared that the panel would focus on why they were putting the bulk of their efforts into blocking pirate services through litigation, rather than getting a commercial service up and running.

The companies agreed to spend the weekend hammering out final MusicNet terms. The negotiations foreshadowed some of MusicNet's later operating difficulties. Holed up at the New York offices of law firm Weil, Gotshal & Manges, representatives of the different labels couldn't even sit together in the same room because of competitive and antitrust concerns. On the advice of lawyers, they spread out to half a dozen conference rooms, with Mr. Glaser urging compromise as he bounced from one to the other.

The final deal, completed early that Monday, put in place a service that would be owned 40% by RealNetworks, with a $13 million investment, and 20% by each of the labels, putting in between $4 million and $5 million apiece.

Hoping to respond to Napster's popularity, the group devised something that was more like a rental model, in which subscribers would have access to songs only for as long as they paid the monthly fee. The music companies wanted generous financial terms, which meant higher charges for the service. RealNetworks, meanwhile, wanted its software, at least initially, to be favored over other technologies, despite the popularity of formats such as MP3 and Microsoft Corp.'s Windows Media.

Mr. Glaser boasted in a news release that MusicNet would "catalyze an exciting new era in digital music distribution." The next day, AOL's Mr. Parsons declared "a breakthrough platform for online music subscription services" before the Senate committee.

But the deal was just the beginning of MusicNet's headaches. Designing the service itself proved even stickier. Because the labels weren't supposed to know each other's business, board members couldn't discuss any details of MusicNet's distribution or licensing agreements, leaving them in the dark about many of the venture's dealings. The MusicNet board had to keep an antitrust attorney present for all discussions.

The tensions surfaced publicly on June 5, when Mr. Glaser announced that Napster would become an affiliate of MusicNet, under a pact that he called "an important step in the process" of bringing legitimate music to the file-swapping company. EMI and Warner Music publicly disputed the significance of the agreement, which they had learned about just a few days earlier. Both said the situation with Napster hadn't changed since they formed MusicNet, and the song-swapping service hadn't met key conditions necessary for getting access to their music. Privately, executives at the two companies were skeptical that Napster would ever be able to use their music legally, even as Napster and MusicNet assured reporters that Napster, RealNetworks and AOL would all be offering MusicNet by late summer.

That timetable proved too optimistic for a venture that didn't even have a permanent chief executive until Mr. McGlade came on board on Oct. 23. The former MTV executive, now 47 years old, soon learned that obstacles to launching the service remained. The record labels had only just completed a pact with music publishers on how the publishers would be compensated for songs bought by MusicNet customers. Still, MusicNet sometimes had to track down the names of individual publishers through Copyright Office records, a slow and cumbersome process.

And in picking through old artist contracts, the labels were trying to solve another thorny problem: They didn't control the rights to digitally distribute songs by prominent artists, including the Beatles, Garth Brooks and the Eagles, who had had the clout to retain the digital rights to their own work. Every few days, MusicNet would get lists from the record labels of what music could be offered on the service, and the results were disappointing. The venture did score one coup when it signed up independent Zomba Recording Corp., which took a small ownership stake and brought in such well-known names as Britney Spears and the Backstreet Boys.

"There was little question from the start that MusicNet would pose an enormous challenge," Mr. McGlade says. "But the fundamentals are sound."

Despite the many gaps in its inventory and unresolved issues, MusicNet made its debut in early December. The first consumer version of the product came via RealNetworks, which began offering a new entertainment software package called RealOne that lets users play audio and video clips and organize song libraries on their PCs. Users first download RealOne, then enter their credit-card numbers in the software, and access premium services, including MusicNet and other entertainment programming.

RealNetworks held a lavish unveiling spiced up by Willa Ford, a young pop singer for Warner's Atlantic Records. But some artists lobbed in last-minute complaints. The day of the launch, for example, BMG officials got a call from a lawyer for the Dave Matthews Band, telling them not to use songs by the popular group. The band, like many other artists, was reluctant to let its music be used in a new, rapidly evolving medium. The songs were yanked, though a Dave Matthews Band CD cover was pictured in some RealNetworks press materials that had already been distributed.

When details of how the service would work were finally made public, consumers shrieked. In the RealNetworks version, a MusicNet customer pays $9.95 a month to download as many as 100 tunes and to access "streamed" songs, meaning they can be played on a computer but not downloaded to its hard disk. Downloaded songs are disabled after 30 days. Customers also can't transfer the music to portable players or CD burners.

Robb Carlson is typical of MusicNet users who want better song selection and the ability burn music onto CDs. "It's great to have it all on a computer, but I'm in my car two to three hours a day," says the 19-year-old freshman at Miami University in Oxford, Ohio.

A week after MusicNet's launch, Universal and Sony announced their service, pressplay, which managed to make

MusicNet look bad. Though pressplay's plan is also lacking, the service does allow consumers to burn a limited number of tracks onto CDs and to assemble an online collection over time.

Something had to be done. In an early December retreat with his fledgling staff at a Seattle hotel, Mr. McGlade passed out New York Fire Department hats to signal that it was time for the company to stop putting out fires and move forward. A couple of weeks later, he told the MusicNet board that the service wasn't viable. The board couldn't discuss such issues in depth because of antitrust issues. As Mr. McGlade began a presentation outlining what changes needed to be made, the company's antitrust lawyer interrupted to say that if he was going to discuss revenue models, he "shouldn't get into specific details," according to a person who was present.

But in later talks with the music companies, Mr. McGlade pushed the labels to offer features such as permanent downloads and portability, according to people familiar with the matter. Mr. McGlade also has laid out financial targets, according to these people. With major expenses including antitrust attorneys, people familiar with the matter say, Mr. McGlade is now seeking a total of about $10 million more from the partners. In addition, these people say, he wants to make MusicNet more attractive to distributors and consumers, in part by lowering the minimum guaranteed amount that the labels would receive for each song consumers download or stream from the service.

There is also an effort to make the service more attractive to other potential distributors, many of whom have thumbed their noses at MusicNet because it's easier and cheaper to get music elsewhere. Sean Ryan, chief executive of San Francisco-based Listen.com Inc., says that he talked to MusicNet about a distribution agreement, but that he thinks he got a better deal when he signed up directly with four of the five major labels to distribute their music. MusicNet "made no sense for us," he says.

All three music companies say they generally support Mr. McGlade's effort to retool MusicNet. EMI Group Executive Vice President John Rose, a MusicNet board member, says his company is "completely aligned" with Mr. McGlade's goals, and MusicNet needs to offer "a full suite of distribution services that people can get from pirate services at a higher level of quality." Bertelsmann's MusicNet board representative, Joel Klein, says: "Nobody thought you would put out a service MusicNet 1.0 and it would not need to be debugged. . . . We knew this was not going to be the last and final offering for MusicNet."

So far, all of MusicNet's roughly 40,000 subscribers are signed up through RealNetworks' version of the service. The much-discussed Napster version of MusicNet never got off the ground. And AOL, which was supposed to be MusicNet's biggest distribution partner, informed Mr. McGlade early this year that it wouldn't sell the service until he made it more attractive for customers. In a trial of about two months, the Internet giant's test audience found that MusicNet was difficult to use, and complained about the limited selection of music and lack of portability.

But, promises Mr. McGlade, "even a year down the road, everything you see today is sure to be radically transformed."

While the music industry has largely succeeded in shutting down Napster, free online music swapping is bigger than ever. Indeed, the big music companies, along with major film studios, last fall filed a lawsuit in federal court in Los Angeles against the companies that offered both the Morpheus peer-to-peer application and the similar Kazaa application, alleging copyright infringement. Representatives of both companies deny any wrongdoing. The lawsuit is pending. Meanwhile, Morpheus has been downloaded 89.3 million times, according to Cnet Networks Inc.'s Download.com. while Kazaa has been downloaded 64 million times.

(See related letter: "Letters to the Editor: Sell to Me Before I `Steal' Again" -- WSJ May 23, 2002)
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EXHIBIT CO 0749

napster.

Napster.com Is Now Free

New Napster.com Allows Free, Legal Listening to Over Two Million Tracks; Offers Exclusive New Ways to Discover, Share and Experience Music Anywhere on the Web

LOS ANGELES, May 1, 2006 /PRNewswire-FirstCall via COMTEX News Network/ -- Napster (Nasdaq: NAPS), unveiled today the new Napster.com, its interactive, ad-supported, free online music destination. With the launch, Napster becomes the first legal digital music service to offer music fans free, on-demand listening to over two million major and independent-label tracks five times each. A Web-based music player enables Napster music to be easily enjoyed anywhere online at no cost and also makes purchasing individual tracks and albums and subscribing to Napster's premium services simple. As part of Napster's comprehensive Web strategy, the Company announced two additional features of Napster.com, NapsterLinks and the soon to be released Narchive, two unique and innovative resources designed to help music fans discover more music and easily share their personal music experiences with other fans. Napster Chairman and CEO Chris Gorog will formally introduce Napster.com today as part of his keynote speech at the 2nd annual MUSEXPO event in Los Angeles. The speech will be broadcast live on the Web at http://investor.napster.com/ or http://www.wsw.com/webcast/cc/naps2/.

(Photo: http://www.newscom.com/cgi-bin/prnh/20060501/LAM051)

In addition to listening to free full-length songs and albums, Napster.com members can search through Napster.com's enormous music catalog and access original artist biographies and exclusive programming features, including over 150 pre-programmed playlists. The new Napster.com is easily accessible to music fans using any Web browser on PC, Macintosh or Linux operating systems, without downloading any software or plug-ins. Listening to Napster.com's extensive music collection for free simply requires creating a member name and password and providing a valid e-mail address. Current Napster subscribers can use their existing member name and password to enjoy Napster.com. The free music experience is initially being introduced in the United States and will be extended to other territories over time.

"Napster was born of the idea of eliminating all barriers to discovering, enjoying and sharing music and of putting the power in the hands of fans," said Chris Gorog, Napster's chairman and CEO. "With a vision to empower music fans in a legal environment, with an open, all-inclusive platform, we are very excited to share our new free music experience at Napster.com."

Napster.com's Exclusive Features Expand the Music Experience

In addition to providing free listening to Napster's massive music library, Napster.com also offers new features designed to encourage the global music community to enjoy a more interactive experience.

NapsterLinks (http://www.napster.com/napsterlinks) enable anyone to add links to free Napster music to e-mails, instant messages, blogs and websites, enabling them to bring text to life with free music. NapsterLinks are URLs that link to specific songs, albums or artists in the Napster.com catalog that can be created using a simple, free tool available on the Web site. Music fans can now share legal music across the Web by putting the NapsterLinks they create into any of their electronic communications. Clicking on a NapsterLink anywhere on the Web causes Napster's Web-based music player to open and begin playing free Napster music.

The Narchive (http://narchive.napster.com) is a public music archive where everyone is invited to contribute to an ever-expanding "People's History of Music." Napster.com members are encouraged to add their unique voices to the Narchive through personal stories, photos and memorabilia. They can also populate their personal entries with free music links from Napster (NapsterLinks) so all members of Napster.com can simultaneously listen to the artists they are reading and writing about.

The Narchive, which will be available as a Beta shortly, offers original biographical information and exclusive photos of artists for anyone to browse. It also features content from some of the foremost authorities in music, such as writer and editor Neil Feineman, who created many of the original featured biographies, and renowned photo archivist Michael Ochs, whose extensive galleries of original photos are featured exclusively in Napster.com.

The Narchive is a community where music fans and experts can all engage in an ongoing, interactive, audio/visual dialogue about anything and everything in the world of music.

Rounding out Napster's comprehensive music offerings are the Napster and Napster To Go subscription services. With Napster, music fans pay one low monthly price and enjoy a premium music subscription experience that includes unlimited access to CD-quality music and advanced discovery, community and programming features. In addition to those premium benefits, Napster To Go members also enjoy unlimited transfer of music to compatible MP3 players, without having to purchase individual tracks and albums a la carte. Both of Napster's premium subscription services are available in a software application that does not contain any advertising. Music fans can also access Napster Light through the ad-free application to purchase individual tracks and albums without paying a monthly fee. Visitors to Napster.com can quickly and easily download the free software application through the "subscribe" tab or via links located throughout the Web site.

"With all the progress the digital music industry has made over the past few years, a digital music model that fully-satisfies everyone -- fans, artists, labels and rights holders -- has yet to surface," continued Gorog. "We believe we have taken a significant step toward achieving this goal and are grateful for the cooperative support of the record industry in making this a reality."

Ad-Supported Business Model Benefits All

With historical visitation of approximately two million unique visitors per month, Napster offers advertisers access to millions of music fans and an association with the most well-known music brand on the Web.

For specific information about advertising opportunities or more information about the Napster.com free music experience, please visit www.napster.com.

About Napster

Napster (Nasdaq: NAPS) is committed to making great music experiences more accessible to all music fans. Napster.com gives web users the power to legally listen on-demand to a massive catalogue of music from major and independent labels, wherever they are on the Web -- for FREE. The Napster music subscription service offers a premium experience that includes unlimited access to CD-quality music and advanced discovery, community and programming features in an advertising-free environment, and Napster To Go subscribers also enjoy unlimited transfer of music to a compatible MP3 player. Napster Light, an a la carte download store, and Napster Mobile, a hosted music service featuring artist images, ring tones and full-length songs, round out the Napster digital music line-up. Napster is headquartered in Los Angeles with offices in Frankfurt, London, Luxembourg, New York, San Diego and Tokyo. For more information, please visit www.napster.com.

Safe Harbor Statement

Except for historical information, the matters discussed in this press release, in particular matters related to the launch and growth of an interactive, ad-supported, online music destination, the expansion of the service to other territories, and the support of the record industry may include forward-looking statements that are subject to certain risks and uncertainties such as decreased demand for our products and services; flaws inherent in our products or services; failure to attract advertisers and sponsors; international regulations; failure to maintain relationships with content providers; and general economic conditions; that could cause actual results to differ materially from those projected. Additional information on these and other factors are contained in Napster's reports filed with the Securities and Exchange Commission (SEC), including the Company's Quarterly Report on Form 10-Q as filed with the SEC on February 8, 2006, copies of which are available at the website maintained by the SEC at http://www.sec.gov. Napster assumes no obligation to update the forward-looking statements included in this press release.

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Napster.com
Frequently Asked Questions (FAQ)
May 1, 2006

Q: If I can listen to each song for free 5 times, what happens when I try to listen to a song for the sixth time?

A: Upon the sixth request for a song, the Napster Web-based player will display a message informing you that you have already enjoyed five free listens of that song, while it plays a 30-second clip. The player will also present you with the option to become a Napster subscriber and enjoy unlimited listening and portability of that song and over two million others in Napster's subscription catalog, or to purchase the song a la carte for 99 cents.

Q: What format do you use for music in the free music player? What is the bitrate?
A: Napster.com members enjoy free listening of songs and albums in .swf flash format, delivered at 32kbps.

Q: Once I become a member of Napster.com, do I need to create another member ID to subscribe to Napster or purchase individual songs and albums?
A: No. When you create a Napster member ID on Napster.com or through the Napster software application, you can use it across all of Napster's services.

Q: Do I have to download any software or provide a credit card to use Napster.com?
A: No. You do not need to download any software or plug-ins to enjoy Napster.com's free music experience and you will never be asked to provide credit card information to listen to free music or access the Napster.com Web site.

Q: Can I access Napster.com from any Web browser? Can I access the site and listen to free music if I am on a Macintosh?
A: The free music and content on Napster.com is available to music fans using a PC or Macintosh, as well as those running Linux. Likewise, the entire Napster free music experience can be enjoyed through a variety of Web browsers, including Internet Explorer, Netscape and Firefox.

Q: Are there any restrictions on the free music available at Napster.com?
A: Napster.com offers music fans the ability to listen for free to every song in a catalog of over two million tracks five times each, and, thanks to Napster's Web-based music player, they can enjoy that free music anywhere on the Web. However, Napster's web-player delivers music as streaming flash files that cannot be downloaded to a computer, burned to a CD or transferred to a portable device.

Q: Where can I get additional information about Napster.com, NapsterLinks and the Narchive?
A: A comprehensive list of frequently asked questions is available at www.napster.com/FAQ.

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2005 PRESS RELEASES

REAL INTRODUCES RHAPSODY.COM, THE FIRST WEB DESTINATION TO OFFER FREE AND LEGAL ACCESS TO A DEEP CATALOG OF FULL LENGTH SONGS FROM ALL MAJOR LABELS

Also Announces Rhapsody Web Services Initiative to Enable Third Parties to Integrate Rhapsody Music Services into their Web Sites

Leading Sites Supporting Rhapsody Web Services Initiative Include Comcast High-Speed Internet, MSN, and Rollingstone.com

SEATTLE — December 05, 2005 — RealNetworks®, Inc. (Nasdaq: RNWK), the leader in digital music subscription services with more than 1.3 million subscribers, today announced the beta launch of Rhapsody.com, a Web-based version of our award-winning digital music service that offers consumers a free and legal way to find, play and share full length songs or albums from a deep catalog that includes all major labels. Any consumer can stream up to 25 on-demand songs per month, while Rhapsody subscribers can stream an unlimited amount via the new Rhapsody.com beta site. Rhapsody.com enables consumers to experience Rhapsody without first downloading a PC jukebox application, and for the first time makes Rhapsody available to Mac and Linux users.

Real is also introducing its new Rhapsody Web Services initiative today, which is intended to enable third party Web sites to access Rhapsody music services via the web. Web portals, community sites, music sites, and other Web sites wanting to integrate music services into their Web experience can now begin to access services such as song playback and editorial content, from the award-winning Rhapsody service.

"With Rhapsody.com, we're bringing the jukebox-in-the-sky to every Internet user in America," said Rob Glaser, chairman and CEO of RealNetworks. "We're also laying the foundation to weave music into the fabric of the Internet with our Rhapsody Web Services initiative."

Rhapsody.com (beta)
For consumers, Rhapsody.com is a first-of-its-kind web destination that enables people to use their favorite Web browser (Internet Explorer, Mozilla Firefox, or Safari) to instantly find, listen, and share up to 25 full tracks from Rhapsody's library of more than 1.4 million songs per month, for free. Consumers also get free, unlimited access to 25 commercial-free radio stations. In addition, subscribers to premium tiers of Rhapsody, including Rhapsody Unlimited ($9.99 per

month) and Rhapsody To Go ($14.99 per month), can now access their accounts via the new Rhapsody.com and stream an unlimited amount of music.

Rhapsody.com makes many of Rhapsody's most popular features available to consumers using Windows and, for the first time, Macintosh and Linux-based PCs. The new web-based service does not require consumers to download additional jukebox software, and there is no credit card registration required to begin using the service. Unlike illegal P2P sites, the music industry is compensated for each song played via Rhapsody.com.

Coinciding with the introduction of the Rhapsody.com beta site, Real is also releasing Rhapsody 3.1, an enhanced version of the desktop software version of Rhapsody. Rhapsody 3.1 includes several enhancements that make it even easier for users to buy and share their favorite tunes and know which songs are available for on-the-go enjoyment via Rhapsody To Go.

Rhapsody Web Services Initiative
Real's new Rhapsody Web Services initiative will enable websites to integrate Rhapsody music services into their websites. Real intends to build multiple components for the Rhapsody Web Services initiative in the coming months, and will work to solicit feedback from the broader Internet community to enhance the initiative. Initial web services available today for third parties include:

- Tools for Web sites to create links, called "Rhaplinks," to individual music tracks, full albums, and radio stations that can be integrated into their Web sites and that enable immediate playback from Rhapsody.com;
- XML feeds, including RSS, of Rhapsody editorial information about music, which third party Web sites can integrate directly into their sites — such as new releases, top 10 tracks, and top 10 albums.
- A blog for third party developers to participate in the future roadmap and development of the Rhapsody Web Services initiative.

More information can be found at www.rhapsody.com/webservices.

Industry Support
Initial companies supporting Rhapsody.com and the Rhapsody Web Services initiative include Comcast High-Speed Internet, RollingStone.com, and Microsoft. Specific implementations include:

- Comcast became the first service provider to launch a new Web-based Rhapsody radio service. The Comcast Rhapsody Web Radio service is currently available to Comcast's 8.1 million broadband customers — the nation's largest broadband base. The service further complements Comcast's online music offering, which also includes: Rhapsody Radio PLUS, Rhapsody Unlimited, and Rhapsody To Go. Comcast Rhapsody Radio provides 50 commercial-free, genre-based stations. In addition to an extra 25 free stations, Comcast customers also can exclusively enjoy a customized station playing The Beatles (www.comcast.net/music).

- RollingStone.com, the official online presence for pop culture icon Rolling Stone, has integrated Rhapsody web services technology throughout its site. The new site, www.RollingStone.com, enables visitors to sample full length free tracks in Rhapsody and view music videos along with the magazine's archive of groundbreaking music news coverage, feature articles, interviews, photos, movie/album reviews and in-depth political reporting.
- In the coming weeks, Rhapsody.com will be available within Microsoft's Windows Media Player 10, and in the coming months, MSN will be using Rhapsody Web Services to integrate Rhapsody into its MSN Search, MSN Messenger and MSN Music services.

"Rolling Stone is continuing to break new ground in helping music fans connect with their favorite artists," said Jann S. Wenner, Chairman of Wenner Media and publisher of Rolling Stone magazine. "Combining Rhapsody's on-demand music with our definitive editorial content makes RollingStone.com one of the web's top music destinations."

"We're thrilled that RealNetworks is bringing their Rhapsody service to Windows Media Player," said Linda Averett, General Manager, Windows Digital Media Division at Microsoft. "This is a fantastic addition to the wide range of choices offered to Windows users, and we're excited to have Real as a partner."

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For more information, visit www.rhapsody.com.

ABOUT REALNETWORKS, INC.
RealNetworks, Inc. is the leading creator of digital media services and software including Rhapsody, RealPlayer® 10, and casual PC and mobile games. RealNetworks has more than 2.2 million paid subscribers to its premium digital media http://www.real.com. Broadcasters, network operators, media companies and enterprises use RealNetworks' products and services to create and deliver digital media to PCs, mobile phones and consumer electronics devices. RealNetworks' corporate information is located at http://www.realnetworks.com/company

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Legal Notice Regarding Forward Looking Statements: This release contains forward-looking statements regarding the anticipated release of one or more products and services and their compatibility and functionality with third party websites and devices that may affect future earnings or financial results. Factors that may impact the forward looking statements include: (a) the success of the deployment and functionality of Rhapsody.com, (b) the success of the development, deployment and adoption of various Rhapsody Web Services; (c) the ability for RealNetworks to obtain and maintain all content rights required from record companies and music publishers to provide various Rhapsody Web Services; (d) RealNetworks' ability to maintain and expand relationships with various third-party partners (e.g. websites, portals, broadband providers and device manufacturers), and

(e) other related factors. Actual results could differ materially from those projected in such forward-looking statements. Additional information concerning factors that could cause our actual results to differ materially from those contained in the forward-looking statements can be found in RealNetworks' filings with the Securities and Exchange Commission ("SEC"), including but not limited to the most recent reports on Forms 10-Q and 10-K, which identify important risk factors that could cause actual results to differ from those contained in the forward-looking statements. Copies of filings made with the SEC are available through the SEC's electronic data gather analysis and retrieval system (EDGAR) at www.sec.gov. RealNetworks assumes no obligation to update the forward-looking statements included in this document.

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STATEMENT BY ASSISTANT ATTORNEY GENERAL R. HEWITT PATE REGARDING THE CLOSING OF THE DIGITAL MUSIC INVESTIGATION

Investigation Reveals the Major Record Labels' Joint Ventures, pressplay and MusicNet, Have Not Harmed Consumers or Reduced Competition

WASHINGTON, D.C. – R. Hewitt Pate, Assistant Attorney General in charge of the Department's Antitrust Division, issued the following statement today after the Department announced the closing of its investigation into the major record labels' pressplay and MusicNet joint ventures:

"The Division's substantial investigation of pressplay and MusicNet has uncovered no evidence that the major record labels' joint ventures have harmed competition or consumers of digital music. Consumers now have available to them an increasing variety of authorized outlets from which they can purchase digital music, and consumers are using those services in growing numbers.

"None of the several theories of competitive harm that the Division considered were ultimately supported by the facts. The Division found no impermissible coordination among the record labels as to the terms on which they would individually license their music to third-party services. The development of the digital music marketplace similarly belies any concerns that the record labels used their joint ventures to stifle the development of the Internet music marketplace and to protect their present positions in the promotion and distribution of prerecorded music in physical form."

(Background information is attached.)

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03-719

DEPARTMENT OF JUSTICE ANTITRUST DIVISION
STATEMENT REGARDING THE CLOSING OF ITS INVESTIGATION INTO THE MAJOR RECORD LABELS' PRESSPLAY AND MUSICNET JOINT VENTURES

Today the Department of Justice announced that it has closed the Antitrust Division's investigation of pressplay and MusicNet, two joint ventures formed by the major record labels to distribute music over the Internet. Pressplay began as a joint venture of major labels Sony Music Entertainment and Universal Music Group, but recently was sold to software supplier Roxio. MusicNet is a joint venture of major labels Warner Music Group, EMI Group, and BMG Music, as well as RealNetworks, an Internet media company.

The digital music world has changed dramatically since the Division opened its investigation in the summer of 2001. In significant part as a result of that change – most notably the emergence of new competitors and Sony's and Universal's sales of their controlling interests in pressplay – the concerns that led the Division to open its investigation have now diminished or disappeared. Consumers can now download individual songs from a growing number of competing digital music suppliers, each of which offers songs from the music catalogs of all five of the major record labels. Consumers also have their choice of subscription-based music services that, for a monthly fee, allow subscribers to browse hundreds of thousands of songs, to listen to "streams" of an unlimited number of songs of their choice, and to download the particular songs they want to "burn" to compact discs or transfer to portable devices.

In its investigation of pressplay and MusicNet, the Division focused primarily on two questions. First, did the joint ventures restrain competition among the major record labels on the terms on which they would license their music to digital music services not owned by the record labels themselves? Second, did the joint ventures allow the major record labels to impede the growth of the Internet as a channel for the authorized promotion and distribution of music, and thereby help the major labels solidify their central roles in the existing music market? Having answered both questions in the negative, the Division has closed the investigation.

Pursuant to the Division's policy on the issuance of investigation closing guidance, *available at* http://www.usdoj.gov/atr/public/guidelines/201888.htm, the Division is providing this brief explanation of its analysis of the record labels' joint ventures. This discussion is limited by the Division's obligation to protect the confidentiality of certain information that it found useful to its analysis. Like all of the Division's investigations, this one has been highly fact-specific, and many of the underlying facts central to the decision are not public. Consequently, readers should not draw overly broad conclusions regarding how the Division is likely to analyze particular collaborations or activities, or transactions involving particular firms, in the future. This statement is not intended to create or affect any party's rights or entitlements nor to bind the Division with respect to any future enforcement action.

The Internet Music Marketplace

When the Division opened its investigation into the major record labels' joint ventures in the summer of 2001, the major record labels had authorized no Internet businesses to allow consumers to search a broad selection of their artists' music and to download selected songs. Millions of consumers instead downloaded software released by entities such as KaZaA and Morpheus, which then allowed them to make unauthorized copies of music files that other users of the same software stored on their computers. The music files that consumers obtained through use of the peer-to-peer file-trading software were typically stored in a file format called "MP3," which compressed songs into computer files that were small enough to be quickly and easily transferred over the Internet. The songs could then be played on a computer, transferred to portable MP3 players, or burned onto blank CDs that could be played by a user's home stereo, car stereo, or portable CD player.

Both joint ventures launched their respective Internet subscription music services in December 2001. At the time of its launch, pressplay (then jointly owned by Sony and Universal) offered to its subscribers music released by major labels Sony, Universal, and EMI. MusicNet (owned by Warner, BMG, EMI, and RealNetworks) offered music released by major labels Warner, BMG, and EMI. Although pressplay allowed its top-tier subscribers an opportunity to download a limited number of songs that were capable of being burned to CDs or transferred to MP3 players, its base subscription package permitted only "streams" and restricted or "tethered" downloads. And MusicNet only offered "streams" or "tethered" downloads. A stream allows the consumer to listen to a song without capturing the song file on his or her computer. To listen to the same song again, the consumer must request that the subscription music service deliver the stream a second time. A tethered download, in contrast, resulted in having the song stored on the subscriber's computer, but the file could not be transferred to portable devices or burned to a CD. The subscriber could listen to the tethered download only via the computer through which he or she had accessed pressplay or MusicNet. These services were widely criticized for their unappealing consumer offerings, and, not surprisingly, they attracted little consumer interest.

The digital music landscape is dramatically different today. The major labels have now authorized a number of entities – only one of which continues to be controlled by major record labels – to deliver the major labels' artists' music to consumers in a variety of different forms. Sales by these authorized digital music outlets have increased substantially in recent months, reflecting increasing consumer acceptance of the current offerings. Several different entities now offer, or have announced plans to offer, a broad selection of major label content that can be downloaded on an *a la carte* basis and transferred to portable devices or burned to CDs. Apple Computer and BuyMusic.com are among the entities currently operating *a la carte* download services, and a diverse group of additional companies including Amazon.com, MTV, Dell, and Microsoft are also reportedly considering services of their own.

In addition, Sony and Universal announced in April 2003 that they had sold pressplay to Roxio, a leading supplier of CD and DVD burning software. On October 9, 2003, Roxio, which had previously acquired the Napster trademark, launched an improved version of pressplay's

subscription service under the name Napster 2.0. Consumers can also subscribe to an improved version of the MusicNet service, or to subscription services offered by RealNetworks and FullAudio.

The Division's Analysis

Reduced Competition in Licensing to Third Parties

The Division closely examined whether the joint ventures diminished competition among the major record labels in the terms on which they licensed their music to third-party music services that sought to compete with the joint ventures. The Division initially was concerned that the licensing by the major record labels to their own joint ventures might provide the major record labels an opportunity to collectively establish the terms on which they would license to third parties. The joint ventures might also have permitted the exchange of competitively sensitive information relevant to each label's licensing considerations.

The Division's investigation of the licensing by the major record labels revealed no evidence that the major labels impermissibly established the terms on which they licensed their music to third parties. Not only did the terms of the licenses that the major labels granted to third parties vary significantly, but it is also apparent that each label adopted its own approach toward the distribution of its music by third parties over the Internet. Safeguards adopted by both pressplay and MusicNet to prevent the sharing of confidential information among their participants also appear to have succeeded in preventing the inappropriate exchange of information among the major record labels through the medium of the joint ventures. Moreover, Roxio's acquisition of pressplay from Sony and Universal has eliminated the possibility of any future information sharing or diminished competition between those two labels that might have been facilitated by their continued involvement in pressplay.

Suppression of the Development of the Internet as a Vehicle for the Promotion and Distribution of Music

The major record labels own the copyrights in the sound recordings associated with over eighty percent of the prerecorded music sold in the United States in the past year. The major labels hold that position, and have maintained it over time, in part because they can promise to artists the resources and expertise necessary to effectively promote and distribute new music. Many believed, however, that by using the Internet, independent record labels or other entities could promote and distribute new music as effectively as the major labels, but at a much lower cost, making them more attractive to artists.

The Division considered in its investigation whether the major record labels used their joint ventures to suppress the growth of the Internet as a means of promoting and distributing music, in order to protect their present positions in the distribution of music on physical media, such as CDs. Proceeding collectively could have allowed the major record labels to explore the use of

the Internet to promote and distribute their music, without relinquishing control over the pace and direction of those activities.

The poor quality and restrictive nature of pressplay's and MusicNet's services at launch in December 2001 provided some support for this theory. As time passed, however, both joint ventures released improved and more consumer-friendly versions of their services, and the major labels licensed their music to a broader array of third-party music services that compete on price and features. Consumers can now download individual songs from broad music collections offered by at least five such services, and might soon be able to choose among a dozen suppliers. The Division concluded from those developments that the major labels are not impeding the promotion and distribution of music over the Internet.

Conclusion

The Division has expended substantial time and resources examining the pressplay and MusicNet joint ventures to determine whether they posed a threat to competition and consumers of digital music. Because its theoretical concerns ultimately were not supported by the evidence, the Division has closed its investigation.

EXHIBIT CO 0752

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In the Matter of	)	
	)	
Mechanical and Digital Phonorecord Delivery Compulsory License	)	Docket No. RM 2000-7

JOINT STATEMENT OF
THE RECORDING INDUSTRY ASSOCIATION OF AMERICA, INC.,
NATIONAL MUSIC PUBLISHERS' ASSOCIATION, INC.
AND THE HARRY FOX AGENCY, INC.

The Recording Industry Association of America, Inc. ("RIAA"), the National Music Publishers' Association, Inc. ("NMPA") and The Harry Fox Agency, Inc. ("HFA"; and collectively with RIAA and NMPA, the "Parties") submit this joint statement to advise the Copyright Office of certain developments relevant to its Notice of Inquiry ("NOI") regarding the application of the mechanical compulsory license of 17 U.S.C. § 115 to certain digital music services.

Specifically, on October 9, 2001, the Parties announced an agreement among them concerning the mechanical licensing of musical works for new subscription services on the Internet (the "Agreement"). A copy of the Agreement is attached as Exhibit A. We briefly describe the Agreement and certain of its benefits below.

BACKGROUND

RIAA is the trade group that represents the U.S. recording industry. Its member record companies create, manufacture and/or distribute approximately 90% of all legitimate sound recordings produced and sold in the United States and comprise the most vibrant

national music industry in the world. They also have authorized the use of their recorded music in digital music services.

NMPA, founded in 1917, works to protect and advance the interests of the music publishing industry. With over 800 members, NMPA represents the most important and influential music publishing firms throughout the United States. HFA, the licensing affiliate of NMPA, provides an information source, clearing house and monitoring service for licensing musical copyrights, and acts as licensing agent for more than 27,000 music publisher-principals, who in turn represent the interests of more than 160,000 songwriters.

As contemplated by the Office's Notice of Initiation of Negotiation Period, 64 Fed. Reg. 38,861 (July 20, 1999), and the relevant statutory provisions, 17 U.S.C. §§ 115(c)(3)(B), (C), (F), the Parties have been negotiating terms and rates of royalty payments for digital phonorecord deliveries made under the mechanical compulsory license provisions of 17 U.S.C. § 115. Because of differences concerning certain legal and procedural questions implicated by the licensing of musical works for use in such services, it took some time for these negotiations to bear fruit. With these differences now resolved, the Parties have established a framework for licensing subscription services offering "On-Demand Streams" and/or "Limited Downloads," which will facilitate the immediate launch of licensed services that will offer consumers a broad array of musical works and diverse methods of electronic music delivery.

The Agreement itself will assist RIAA members in making music available to consumers through subscription services on a prompt and widespread basis. Moreover, it is HFA's intention to make licenses widely and directly available to any service that is willing to adopt this framework or to negotiate a mutually agreeable alternative. The Agreement also

aims at simplifying and expediting the mechanical rights licensing process. Whether a service obtains its licenses through an RIAA member or directly from HFA, the Agreement assures that an entity seeking to offer legitimate services will have the opportunity to obtain the appropriate licenses promptly and through procedures that are not burdensome. By resolving disagreements over the nature and scope of the licenses needed by services and providing a streamlined process for obtaining the necessary licenses, the Agreement also fosters competition in the nascent online music marketplace.

TERMS OF THE AGREEMENT

In the following paragraphs we describe in general terms certain key provisions of the Agreement.

What Type of Services Are Covered? The Agreement applies to subscription digital music services that include among their offerings "On-Demand Streams" and/or "Limited Downloads" (collectively, "Covered Services"). An "On-Demand Stream" is an on-demand, real-time transmission of a song to a consumer who requests that song using streaming technology, such as Real Audio or Windows Media Audio. A "Limited Download" is a download that can be played for a limited period of time or a limited number of plays. (Agt. §§ 1.1-1.4.)

Who Is Covered? Under the Agreement, a mechanical license pursuant to 17 U.S.C. § 115 for On-Demand Streams and Limited Downloads made through Covered Services is available through HFA to all RIAA member companies and to any digital music service that is majority owned by one or more RIAA members. As provided by 17 U.S.C. § 115(c)(3)(A), the rights under a license extend to any Covered Service operated by the licensee and can be extended to any Covered Service authorized by the licensee to make On-Demand Streams and/or Limited Downloads of a licensed musical work. (Agt. Art. 1.) In addition, NMPA and

HFA have publicly stated that it is their policy to license not only RIAA members but also other digital music services that wish to negotiate comparable agreements. (See, e.g., *Music Publishers Support Landmark Accord with Record Industry For Launch of Internet Subscription Services* (November 27, 2001), *available at* http://www.nmpa.org/pr/internet_subscription.html.)

What Rights Are Included? A mechanical license obtained under the Agreement includes all reproduction and distribution rights for delivery of On-Demand Streams and Limited Downloads through Covered Services. The Agreement confirms that a mechanical license for these services includes the right to make server copies, buffer copies and other related copies used in the operation of Covered Services. The Agreement also includes a royalty-free cross license for On-Demand Streams of promotional excerpts of sound recordings and musical works. A license does not include performance rights, which are licensable separately through performing rights organizations such as ASCAP, BMI and SESAC. (Agt. Art. 2.)

What Will Be the Licensing Process? The Agreement streamlines procedures for obtaining licenses through HFA. In particular, an electronic "bulk" licensing process should allow licensees to obtain large numbers of licenses very quickly. To facilitate the expeditious launch of services, licenses can be requested at once and will be retroactive to the date of request. Works will be licensed in their entirety. That means that if multiple publishers co-own the copyright in a particular song, HFA will license use of the song if it represents any one of them, with no need to obtain mechanical licenses for the same song from the other co-owners. The licensee, however, is required to pay directly to any co-owner not represented by HFA that co-owner's share of the royalties. As always, the authority of HFA to license a

particular song on behalf of a music publisher is subject to the approval of the publisher. HFA also will attempt to arrange licenses of songs where it does not represent any of the copyright owners, subject to such owner's authorization of HFA to conclude such licenses. The Agreement is nonexclusive in every respect:

- Record companies and Internet music services are free to obtain compulsory licenses other than through HFA by serving notices of intention directly on copyright owners or filing them in the Copyright Office.
- While record companies may authorize Internet music services to distribute phonorecords of licensed musical works online, pursuant to Section 115(c)(3)(A) of the Copyright Act, Internet music services are also free to obtain licenses directly from HFA or individual music publishers. (Agt. Art. 3.)

Does the Agreement Establish a Royalty Rate? The Agreement does not include specific royalty rates for On-Demand Streams and Limited Downloads made through Covered Services. The Parties have committed to negotiate those rates pursuant to 17 U.S.C. §§ 115(c)(3)(B), (C) and (F), which provide that copyright owners and persons entitled to obtain a compulsory license "may negotiate and agree upon the terms and rates of royalty payments under [the compulsory license] . . . and may designate common agents to negotiate, agree to, pay or receive such royalty payments." We hope to submit such rates to the Office for adoption pursuant to 37 C.F.R. § 251.63(b). If the negotiations are not successful the applicable rate shall be determined by a copyright arbitration royalty panel ("CARP"), pursuant to 17 U.S.C. §§ 115(c)(3)(D) and (F). (Agt. Art. 5.)

Pending the Establishment of a Royalty Rate, How Are Publishers Compensated? RIAA has paid HFA a nonrefundable advance payment of $1 million. If the statutory royalty rate is not set within two years, RIAA will pay HFA further advances of $62,500 per month (subject to adjustment in certain circumstances and to the right of RIAA or particular members to opt out of the Agreement). The advances are recoupable and may be applied to

any amounts owed by any participating licensee under mechanical licenses issued by HFA for On-Demand Streams and Limited Downloads made through Covered Services. (Agt. Art. 4.)

What Are the Accounting and Payment Procedures Under the Agreement? Licensees will account to HFA on a quarterly basis beginning with the issuance of a license. Upon the final determination of the applicable statutory royalty rates, licensees will pay for their past activities (to the extent not covered by the advance) and thereafter account and pay quarterly. Quarterly reports will include certain specified usage information and certain other information that may be requested by HFA. (Agt. Art. 6.)

What Are the Legal Issues Resolved by the Agreement? The Agreement confirms the Parties' mutual understanding of certain principles of current copyright law that provide the underpinnings for the licensing process contemplated by the Agreement. Specifically, it is agreed that (1) the process of making On-Demand Streams and of making Limited Downloads through Covered Services (from the making of server copies to the transmission and local storage of the stream or download), viewed in its entirety, involves the making and distribution of a "digital phonorecord delivery" or "DPD"; (2) a compulsory license is available under 17 U.S.C. § 115 for On-Demand Streams and Limited Downloads made through Covered Services; and (3) radio-style and other non-interactive webcasting that would qualify for a statutory license under 17 U.S.C. § 114(d)(2) does not involve the making or distribution of a DPD, and thus does not require a mechanical license.[1] (Agt. § 8.1.)

[1] Because the Parties believed that record companies and music publishers and certain of their subsidiaries should not be able to benefit from the Agreement while challenging it in an adversarial proceeding, the Parties agreed not to advocate contrary positions in certain contexts.

BENEFITS OF THE AGREEMENT

The Parties believe that this Agreement is an important milestone in the development of the online music marketplace that will give consumers access to more and better online music options, sooner. The Agreement has many benefits:

- The Agreement will facilitate the immediate launch of licensed music services that will offer consumers a broad array of musical works and diverse methods of electronic music delivery. The Parties anticipate that On-Demand Streams and Limited Downloads will take their place in the digital music marketplace alongside full downloads (for which compulsory licenses are already available at the current statutory mechanical rate). Music service providers may choose to offer some or all of these services to their subscribers. The Agreement assures that an entity seeking to offer legitimate services across this range of options will have the opportunity to obtain the appropriate licenses promptly and through procedures that are not burdensome.

- The Agreement will assist both record companies and Internet music services in launching subscription services on the Internet. The Agreement is nonexclusive, so Internet music services will have the option of obtaining licenses directly from HFA or individual publishers, or seeking authorization from record companies that take licenses under the Agreement.

- The Agreement resolves the Parties' differences over legal aspects of licensing musical works for certain online services. The Agreement will thus allow the Parties more productively to pursue negotiation of terms and rates of royalty payments.

- The Agreement confirms the parties' belief that the compulsory mechanical license provisions of the Copyright Act provide broad access to musical works for recording and distribution, including online distribution.

- It is clear that server copies will be licensed under the Agreement. Having ready access to licenses that include the right to make server copies will be particularly reassuring for companies seeking to launch services.

- The Agreement simplifies and expedites the process for licensing mechanical rights for Covered Services. Some newcomers to the music industry have complained about "complexity" in music rights licensing. The Agreement aims at simplifying and expediting the mechanical rights licensing process. It provides for electronic "bulk" licensing to allow companies to obtain mechanical licenses very quickly. The procedures will allow a potential licensee to request licenses for multiple titles at the same time. To facilitate the launch of services, licenses issued will be retroactive to the date of request. Moreover, for musical works owned by multiple copyright owners, HFA will issue a license if it represents any one of those owners, subject to the licensee paying the non-HFA co-owner its share of the royalties directly. As a further undertaking, HFA will also

attempt to arrange licenses for songs even when it does not represent any of the copyright owners, subject to its receiving authorization from the copyright owners to do so.

- By resolving disagreements over the nature and scope of the licenses needed by services and providing a streamlined process for obtaining the necessary licenses, the Agreement fosters competition in the nascent online music marketplace. NMPA and HFA have publicly stated that it is their policy to license not only RIAA members but also other digital music services that wish to negotiate comparable agreements, and NMPA and HFA recently announced that they have entered into such an agreement with Listen.com. This offer should make it easier for new services to enter the online music marketplace, thus promoting competition in that market.

- The Agreement provides a framework to establish fair royalty rates, thereby encouraging songwriting by providing for the payment of a fair royalty to songwriters for their creative efforts, while ensuring that services can launch and operate in the interim. Although the Agreement does not establish a royalty rate for On-Demand Streams or Limited Downloads, the parties have committed to engage in good faith negotiations to arrive at such a rate (or rates). If negotiations fail, an applicable rate (or rates) will be established by a CARP convened by the Copyright Office. In the interim, however, the Agreement allows licensees to launch their services now and pay the royalties due on a retroactive basis once rates are established.

- The Agreement represents the type of marketplace solution that Congress has urged to resolve these business and legal issues.

CONCLUSION

The Parties are excited about the opportunity that digital music services present as a new outlet for the distribution of music and are committed to promoting the expeditious launch of such services. The Parties hope that the Office finds this information about the Agreement helpful as it considers the issues raised in the NOI.

Dated: December 6, 2001

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Agreement

This agreement (the "Agreement"), dated as of October 5, 2001 ("Effective Date"), is made by and between the Recording Industry Association of America, Inc. ("RIAA"), on the one hand, and National Music Publishers' Association, Inc. ("NMPA") and The Harry Fox Agency, Inc. ("HFA"), on the other (all of the foregoing collectively referred to as the "Parties").

WHEREAS, record companies desire to offer to consumers, or authorize others to provide to consumers, certain digital music services that provide On-Demand Streams and Limited Downloads (as defined below);

WHEREAS, music publishers desire to make their copyrighted musical works widely available to consumers by licensing such services;

WHEREAS, while the Parties have differed concerning certain legal and procedural questions implicated by the licensing of musical works for use in such services, record companies have always believed that musical work copyright owners should receive for the use of musical works in digital music services a fair royalty that reasonably reflects the value of the use of those works, irrespective of the particular rights of the copyright owner applicable to that use, and music publishers have always believed that their copyrighted works should be made available through such services for fair compensation;

WHEREAS, there has been litigation concerning the use of musical works in digital music services; the U.S. Copyright Office has issued a Notice of Inquiry whether to conduct a rulemaking concerning the legal status of On-Demand Streams and Limited Downloads; the U.S. Copyright Office has issued a report pursuant to Section 104 of the Digital Millennium Copyright Act addressing certain issues relating to streaming; and certain record companies may prefer to make business decisions concerning the launch of Covered Services (as defined below) with greater assurance concerning the legal status of such services;

WHEREAS, the Parties desire to avoid the uncertainty and expense of litigation concerning the use of copyrighted musical works by Covered Services, and to provide assurance to record companies and others seeking to offer such services to consumers;

WHEREAS, Section 115(c)(3) of the U.S. Copyright Act authorizes voluntary negotiations for determining royalty rates and terms under the mechanical compulsory license; and

WHEREAS, in settlement of their differences and to facilitate the expeditious and widespread launch of digital music services, the Parties have reached this Agreement with respect to terms pursuant to which RIAA member record companies may obtain licenses to make and authorize On-Demand Streams and Limited Downloads of musical works in Covered Services;

NOW, THEREFORE, pursuant to 17 U.S.C. § 115(c)(3), and in consideration of the mutual promises contained in this Agreement and for other good and valuable consideration, the

adequacy and sufficiency of which are hereby acknowledged, the Parties hereby agree as follows:

1. Covered Services. Any member of RIAA that seeks to use, or authorize the use of, a copyrighted musical work for which an HFA publisher-principal has the right to grant the rights that are the subject matter of this Agreement in connection with the operation of one or more Covered Services may obtain through HFA on behalf of such HFA publisher-principal a mechanical license ("License") to make On-Demand Streams and Limited Downloads of the work through Covered Services, through to the end user, including by making server and related reproductions of the work used in the operation of Covered Services.

1.1. "Covered Service" means a service that offers (but the offerings of which are not necessarily limited to) On-Demand Streams and/or Limited Downloads of sound recordings of musical works from servers located within the United States (including the territories and possessions thereof), where the basic charge to users for the service is a recurring subscription fee (in contrast to the basic charge being a per-download, per-play or per-song fee), including any use of such a service on a limited basis without charge to users in order to promote the subscription service.

1.2. "On-Demand Stream" means an on-demand, real-time digital transmission of a sound recording of a single musical work to allow a user to listen to a particular sound recording chosen by the user at a time chosen by the user, using streaming technology, which may include but is not limited to Real Audio or Windows Media Audio, that is configured by the provider of the Covered Service in a manner designed so that such transmission will not result in a substantially complete reproduction of a sound recording being made on a local storage device (*e.g.*, the hard drive of the user's computer or a portable device) so that such reproduction is available for listening other than at substantially the time of the transmission.

1.3. "Limited Download" means a digital transmission of a time-limited or other use-limited download of a sound recording of a single musical work to a local storage device (*e.g.*, the hard drive of the user's computer or a portable device), using technology designed to cause the downloaded file to be available for listening only either (1) during a limited time (*e.g.*, a time certain or a time tied to ongoing subscription payments) not to extend more than thirty (30) days beyond the expiration of the user's subscription, or (2) for a limited number of times not to exceed twelve (12) times after the expiration of the user's subscription.

1.4. Any member of RIAA that obtains a License hereunder is referred to herein as a "Participating RIAA Member." Any member of NMPA or HFA publisher-principal that grants a License and/or accepts a portion of an Advance Payment hereunder is referred to herein as a "Participating NMPA/HFA Publisher." The terms "Participating RIAA Member" and "Participating NMPA/HFA Publisher" are limited to such entities and their majority-owned subsidiaries.

1.5. Any digital music service that is majority owned by one or more RIAA members in the aggregate shall be entitled directly to obtain a License hereunder, and so shall be treated as a "member of RIAA" for purposes of Section 3.1. If such a service either obtains a License directly or is authorized under a License hereunder to make On-Demand Streams and/or

Limited Downloads through Covered Services, such service shall be treated as a "Participating RIAA Member" for all purposes of this Agreement.

2. Covered Deliveries.

2.1. A License with respect to a musical work includes all reproduction, distribution and DPD rights necessary for Covered Services to make On-Demand Streams and Limited Downloads of that work, from the making of server reproductions to the transmission and local storage of the On-Demand Streams or Limited Downloads. A License does not extend to other transmissions made by a Covered Service or to activities not encompassed by a mechanical license, including, without limitation, print or display rights, merchandising rights, adaptation (derivative work) rights except as provided in Section 115(a)(2) of the Copyright Act, rights to synchronize musical works with visual images resulting in audiovisual works, or karaoke rights, all of which rights are specifically reserved. The Parties agree that server reproductions made under a License to transmit On-Demand Streams or Limited Downloads may be used to make transmissions other than On-Demand Streams and Limited Downloads; provided that the foregoing is without prejudice to any applicable requirement, if any, that the Participating RIAA Member also obtain a license for such other transmissions made using such server reproductions. It is understood that this Agreement does not address or extend to any performance rights that may be implicated by the making of On-Demand Streams or Limited Downloads through Covered Services.

2.2. A License includes the right to make, and there shall be no separate payment or accounting for, On-Demand Streams of Promotional Excerpts (as defined below) of sound recordings of musical works licensed hereunder used for promotional purposes, provided that the applicable Participating RIAA Member shall be deemed likewise to authorize the relevant copyright owner or copyright owners of such musical work (or an organization of copyright owners designated by such copyright owners as their common agent) to make On-Demand Streams of Promotional Excerpts of that sound recording for the purpose of promoting that musical work without payment of any royalty. "Promotional Excerpt" is defined as a stream consisting of no more than thirty (30) seconds of playing time of the sound recording of a musical work, or in the case of sound recordings with a playing time of more than five minutes, a stream that is of no more than the lesser of ten percent (10%) or sixty (60) seconds of playing time of the sound recording of the musical work.

3. Licensing Process.

3.1. Commencing on the Effective Date, a member of RIAA may submit License requests in electronic form, either individually or batched, and either for On-Demand Streams and/or Limited Downloads alone or in combination with other configurations, substantially in accordance with Exhibit A. Promptly after the Effective Date, during the opt-out period described in Section 3.2, the Parties shall arrange discussions between appropriate personnel of HFA and of certain RIAA members concerning electronic licensing procedures, with the goal of refining and testing HFA's electronic licensing procedures so that they can be used readily for the issuance of mechanical licenses expeditiously following the completion of such opt-out period, and with the goal of enhancing such procedures so that they later can be used readily by RIAA members to request and obtain mechanical licenses for all configurations for which they

desire licenses in a single request. In addition, a member of RIAA may submit License requests by other means generally accepted by HFA, including but not limited to SirNet (for so long as it is available), HFA's new web-based licensing system (when it becomes available), and HFA's standard paper form (but only using paper forms for complex License requests (e.g., requests involving medleys or samples), in limited numbers during times when electronic licensing capabilities are unavailable, or at other times in numbers that are generally consistent with such RIAA member's past use of paper forms, and in any case in numbers that do not exceed what HFA can reasonably be expected to process under the circumstances). HFA may modify its license request and license forms from time to time, provided that it gives reasonable notice thereof to RIAA and Participating RIAA Members and such modifications do not unreasonably affect the ability of Participating RIAA Members to submit license requests and obtain licenses. License forms may be issued electronically or in paper form, but when a Licensee submits a License request in electronic form in accordance with this Section 3.1, HFA shall, promptly after processing the License request, return to such Licensee an electronic file substantially in accordance with Exhibit A, with (1) the addition of that information indicated in Exhibit A as being "output" fields, (2) the addition of information, other than individual publisher share information, to complete any blank optional fields in the request, to the extent that such information is available in HFA's databases and is matched to the request in the License issuance process, (3) the substitution of information concerning HFA publisher-principal names where such information in HFA's databases is different from that in the request, and (4) the aggregated share of Participating NMPA/HFA Publishers. If an RIAA member submits a License request in accordance with this Section 3.1 but the request contains insufficient information for HFA to find a match for the relevant work in its databases, HFA will work with such RIAA member to provide the information necessary to enable a License to be issued, and if such RIAA member resubmits such request with the necessary information and the License can be issued, the provisions of Section 3.4 shall apply from the date of the original request. The Parties acknowledge the importance to NMPA, HFA and music publishers of having License requests submitted promptly, and the importance to RIAA and record companies of having License forms issued promptly. The Parties shall cooperate in good faith to promote each of those goals.

3.2. The authority of HFA to license any individual musical work on behalf of its publisher-principals is subject to the approval of the relevant publisher-principal. HFA shall not require its publisher-principals to opt in to this Agreement either before or after commencing to issue Licenses, but HFA may establish an opt-out period before commencing to issue Licenses, provided that such period ends not later than six (6) weeks following the Effective Date. If an HFA publisher-principal at any time requests that HFA not issue Licenses on its behalf (either with respect to particular musical works or in general), HFA will honor that request; provided, however, that any such request shall not affect the validity or subsistence of a License issued prior to such request. During the opt-out period described in Section 3.2, HFA shall notify RIAA weekly of HFA publisher-principals that have notified HFA that they do not wish to make Licenses of their works available under this Agreement. Thereafter, through December 31, 2002, HFA shall notify RIAA quarterly of HFA publisher-principals that have notified HFA that they do not wish to make Licenses of their works available under this Agreement.

3.3. HFA shall issue mechanical licenses for DPD configurations (including but not limited to Licenses under this Agreement) with respect to a musical work in its entirety if one or more of its publisher-principals owns or controls a partial interest in such musical work, even if other co-owners of such musical work are not HFA publisher-principals, except that, pursuant

to Section 3.2, if all the HFA publisher-principals that own or control a partial interest in such work request that HFA not issue mechanical licenses on their behalf, HFA will not issue such licenses. In the case of a mechanical license issued as descibed in this Section 3.3, a Participating RIAA Member shall pay directly to each co-owner that is not an HFA publisher-principal (or such co-owner's authorized payee) such co-owner's share of the applicable royalty payments under Section 6.1.

3.4. License forms issued by HFA pursuant to this Agreement shall be retroactive to the date of the License request made by the Participating RIAA Member on or after the Effective Date in accordance with Section 3.1. To the extent that the Participating RIAA Member makes or authorizes On-Demand Streams and Limited Downloads of musical works pending the processing by HFA of license forms in response to proper License requests submitted on or after the Effective Date in accordance with Section 3.1, NMPA and HFA shall not directly or indirectly file, encourage, aid, support, finance, contribute to, promote, or participate in any claim, suit, action or proceeding asserting that such activities are infringing.

3.5. Subject to Section 3.3, HFA shall also accept License requests to make On-Demand Streams and Limited Downloads through Covered Services of musical works as to which no HFA publisher-principal has any ownership interest or control, in whole or in part, and for which a License is not otherwise available under this Agreement. In such a case, HFA shall use commercially reasonable efforts to secure the requested Licenses from the relevant non-HFA publisher-principals on the same terms as apply to HFA publisher-principals under this Agreement. (Non-HFA publisher-principals who grant Licenses through this arrangement shall be referred to as "Participating Independent Publishers".) In addition to any commission charged to the Participating Independent Publisher, HFA may charge the relevant Participating RIAA Member a one-time administrative fee of ninety-five dollars ($95) for each publisher that agrees to become a Participating Independent Publisher (it being understood that no such administrative fee shall be payable for any subsequent Licenses issued on behalf of that Participating Independent Publisher to any Participating RIAA Member), unless the Participating Independent Publisher also authorizes HFA to grant mechanical licenses other than Licenses under this Agreement, in which case no such fee shall apply. The Advance Payment described in Article 4 may be applied to such administrative fee when payable by a Participating RIAA Member specified by RIAA, and HFA shall provide to RIAA or an independent accounting firm designated by RIAA sufficient information concerning liability for such administrative fee to allow reconciliation of the Advance Payments as described in Section 4.4. When HFA arranges Licenses from Participating Independent Publishers pursuant to this Section 3.5, HFA shall collect and distribute mechanical royalties to such Participating Independent Publisher (or other authorized payees) unless the Participating RIAA Member requests to make such payments directly.

3.6. It is understood that compilations of data supplied by HFA in electronic form pursuant to Section 3.1, except to the extent that they consist of data provided by the relevant Participating RIAA Member pursuant to Section 3.1, are proprietary in nature and shall not be used by the recipient Participating RIAA Member to engage in business activities in competition with HFA or for any purpose other than to request and administer licenses issued by HFA and/or other licenses such Participating RIAA Member acquires with respect to the same works or other works owned or controlled by the same copyright owners, and shall not be disclosed by the recipient Participating RIAA Member to any other party except insofar as it is reasonably

necessary to disclose specific data relating to particular works for the purpose of requesting or administering licenses issued by HFA and/or other licenses such Participating RIAA Member acquires with respect to the same works or other works owned or controlled by the same copyright owners.

3.7. Nothing in this Agreement, including but not limited to the availability of Licenses or the procedures for obtaining the same, shall preclude an RIAA member or digital music service from at any time serving or filing a notice of intention to obtain a compulsory license in accordance with applicable law or, other than in Article 8, imply that any notice of intention so served or filed is valid or invalid. Nothing in this Agreement shall preclude any digital music services from seeking, or HFA or any of its publisher-principals from granting, direct licenses to digital music services, including without limitation Covered Services, on whatever terms might be agreed upon between the relevant parties, and it is the intention of HFA to make such licenses widely available as described more fully in a press release to be issued by HFA. By taking Licenses pursuant to this Agreement, Participating RIAA Members will be able to facilitate on a prompt and widespread basis the availability of music over the Internet through Covered Services.

4. Advance Payment.

4.1. Within thirty (30) days after the Effective Date, RIAA, on behalf of Participating RIAA Members (including their licensees), shall pay to HFA a non-refundable advance royalty payment of one million dollars ($1,000,000) in the aggregate ("Advance Payment"). If, by the second anniversary of the Effective Date, there has then been no final non-appealable determination of royalty rates for On-Demand Streams and Limited Downloads through negotiation and/or a CARP proceeding, as the case may be, then, subject to Section 4.2, until such a determination, RIAA, on behalf of Participating RIAA Members (including their licensees), shall each month pay to HFA a supplementary Advance Payment of sixty-two thousand five-hundred dollars ($62,500) in the aggregate.

4.2. Effective at the second anniversary of the Effective Date or any time thereafter, RIAA may terminate this Agreement upon thirty (30) days advance written notice to NMPA and HFA. In the event RIAA does so, all Licenses previously issued under this Agreement shall terminate at the same time as this Agreement, without prejudice to the right of Participating RIAA Members thereafter to obtain new licenses under 17 U.S.C. § 115. Effective at the second anniversary of the Effective Date or any time thereafter, any Participating RIAA Member may opt out of this Agreement upon thirty (30) days advance written notice to each of the Parties. In the event a Participating RIAA Member does so, (1) the provisions of this Agreement thereafter shall not apply to such Participating RIAA Member except as provided in Article 7, and (2) all Licenses previously issued to such Participating RIAA Member under this Agreement shall terminate at such time, without prejudice to the right of such Participating RIAA Member thereafter to obtain new licenses under 17 U.S.C. § 115. In the case of termination by either RIAA or one or more Participating RIAA Members, (a) payments shall be due in accordance with Section 6.1 for activities under this Agreement prior to the termination of the relevant Licenses, (b) Advance Payments may be applied against such payments in accordance with Section 4.4, and (c) to the extent remaining, Advance Payments also may be applied to royalties due under new licenses for On-Demand Streams and Limited Downloads made through Covered Services, which licenses are issued by HFA at least one year after the

relevant date of termination to the Participating RIAA Members whose Licenses were terminated. In addition, in the event a Participating RIAA Member that is one of the five "major record companies" (as that term is commonly understood, including any successors thereto and the subsidiaries thereof) so opts out of this Agreement, RIAA's monthly supplementary Advance Payments under Section 4.1 thereafter shall be reduced proportionately, based on the number of major record companies at such time (e.g., if there are then five major record companies and one opts out, RIAA's monthly supplementary Advance Payments shall be reduced by twenty percent (20%)). In addition to the foregoing, if there is a decision of the U.S. Copyright Office or a court, or any new legislation, inconsistent with Section 8.1, with the result that mechanical royalties are not required to be paid for some or all On-Demand Streams and/or Limited Downloads made through Covered Services, then the amount of RIAA's monthly supplementary Advance Payments under Section 4.1 shall be reduced to take into account such decision or legislation, based on actual usage under this Agreement to date, with the exact amount of such reduction to be agreed upon by the Parties promptly after such decision or legislation; provided that if any such decision is appealed and finally reversed on appeal, the amount of RIAA's monthly supplementary Advance Payments under Section 4.1 shall be restored, and RIAA shall promptly pay to HFA the total amount by which the supplementary Advance Payment was reduced in the interim.

4.3. HFA shall deposit Advance Payments into an interest-bearing bank account (with such interest being treated as part of the Advance Payment). HFA shall be free to distribute the initial and supplementary Advance Payments to HFA publisher-principals in accordance with a reasonable and nondiscriminatory methodology based on market share, actual usage or a per musical work payment (which methodology HFA shall provide to RIAA), as well as to any Participating Independent Publishers pursuant to Section 3.5. Except insofar as it is recouped pursuant to Sections 4.4 and/or 4.5, the Advance Payment shall be nonrefundable.

4.4. Upon the final non-appealable determination of royalty rates for On-Demand Streams and Limited Downloads through negotiation and/or a CARP proceeding, as the case may be, the total amount of Advance Payments (including interest) shall be applied against undisputed amounts owed to HFA on behalf of its publisher-principals and Participating Independent Publishers by Participating RIAA Members under this Agreement. Such Advance Payments shall be applied to the accounts of individual Participating RIAA Members as specified by RIAA, or an independent accounting firm designated by RIAA, by written notice to HFA within 45 days after the date of such final non-appealable determination of royalty rates. If the Advance Payments are not fully recouped at such time, any remainder of the Advance Payments thereafter shall be applied against all undisputed amounts owed to HFA on behalf of its publisher-principals and Participating Independent Publishers by Participating RIAA Members identified by RIAA, under mechanical licenses issued by HFA for On-Demand Streams and Limited Downloads made through Covered Services (including but not limited to Licenses under this Agreement), until such amount is fully recouped, unless RIAA notifies HFA of a different allocation of the Advance Payments among the accounts of Participating RIAA Members from time to time. HFA shall provide to RIAA or an independent accounting firm designated by RIAA sufficient accounting information to allow payments between RIAA and Participating RIAA Members, or vice versa, as necessary for each Participating RIAA Member ultimately to have paid to RIAA a net amount equal to that portion of the Advance Payments recouped by royalties actually owed by such Participating RIAA Member hereunder.

4.5. At the request of HFA, with RIAA's written consent, which consent shall not be withheld unreasonably, Advance Payments may be applied to other undisputed amounts (*e.g.*, other mechanical royalties) owed by Participating RIAA Members to HFA on behalf of its publisher-principals.

5. Royalty. The royalty rate payable under a License shall be determined through negotiation and/or a CARP proceeding. The applicable rate will be structured as determined through negotiation or by the CARP, and may comprise separate royalty rate components for distinct uses of the musical work authorized by the License. The Parties shall meet to negotiate royalty rates in good faith, with the goal of concluding such negotiations promptly after the launch of Covered Services, and if an agreement is reached, jointly petition the U.S. Copyright Office for its adoption pursuant to 37 C.F.R. § 251.63(b). NMPA reserves its right to seek interest as a part of such royalty rate determination. RIAA reserves its right to seek to have such royalty rate determination reflect any payments under foreign copyrights in the case where On-Demand Streams or Limited Downloads are transmitted to users outside of the United States. Whether royalty rates are determined by negotiation or a CARP, and regardless of how royalty rate categories may be denominated, the Parties shall seek a determination of royalty rates such that it is clear which royalty rates are applicable to each of On-Demand Streams and Limited Downloads.

6. Accounting and Payment.

6.1. Beginning with the issuance of a License, a Participating RIAA Member will be required to account to HFA on a quarterly basis for activity under such License, 45 days after the close of each quarter, providing information comparable to that presently provided for physical products, and specifically including the number of On-Demand Streams and Limited Downloads of each work made during such quarter. Without limitation, quarterly reports shall include a breakdown of On-Demand Streams and Limited Downloads made by Covered Services under Licenses in the applicable quarter, by musical work and delivery method code (indicating On Demand-Streams and/or Limited Downloads), and including ISRC number if available, catalog number if available and HFA license number if available (in the same manner indicated by the Participating RIAA Member in its License request), and shall identify the specific Covered Services in which such On-Demand Streams and Limited Downloads were made. Each Participating RIAA Member shall preserve all usage and financial data that reasonably should be expected to be relevant, upon the determination of royalty rates, to the calculation of royalties hereunder and use commercially reasonable efforts to require that each Covered Service it has authorized hereunder to make On-Demand Streams and Limited Downloads does the same. Subject to Article 4 and Section 3.3, upon the final non-appealable determination of royalty rates for On-Demand Streams and Limited Downloads through negotiation and/or a CARP proceeding, each Participating RIAA Member shall make the applicable payment for all previous quarters then completed, from the launch of the applicable Covered Services to date, within 45 days, to be accompanied by a cumulative statement setting forth and aggregating the information provided in the previous quarterly reports supplied under this Agreement. Thereafter, on a quarterly basis, 45 days after the close of each quarter, each Participating RIAA Member shall account to HFA for activities and/or revenues realized on such activities during such quarter as determined through negotiation and/or by regulation, providing such information as is required by regulation, a CARP, and/or a negotiated rate agreement, and, subject to Article 4 and Section

3.3, pay royalties at the applicable rate. Notwithstanding the foregoing, NMPA reserves its right to seek more frequent access, including without limitation real-time access, to usage information.

6.2. At the request of HFA, a Participating RIAA Member shall accompany its quarterly reports with any available data in addition to that described in Section 6.1 concerning the numbers of On-Demand Streams and Limited Downloads made through Covered Services operated or authorized by such Participating RIAA Member (but not any personally identifying information), which data is regularly gathered or compiled by such Participating RIAA Member or provided to such Participating RIAA Member by its licensees with the right to disclose such data to HFA hereunder; provided that a Participating RIAA Member may provide any such data to HFA in whatever form it is available to such Participating RIAA Member in the ordinary course of its business and subject to any applicable confidentiality and other contractual use restrictions; and provided further that, before making any such request, HFA shall review with the Participating RIAA Member the types of such data the Participating RIAA Member has and can disclose to HFA, and the form in which such data is available, and HFA shall not request, and Participating RIAA Members shall not be required to provide, data that (given the volume and form of such data, the degree to which such data is reflected in quarterly reports, the data processing capabilities of HFA and the Participating RIAA Member, HFA's intentions to use such information, and other relevant factors) would not be commercially reasonable to provide. In addition, to the extent such information is available to a Participating RIAA Member and can be disclosed to HFA hereunder, at the request of HFA, a Participating RIAA Member shall accompany its quarterly reports with the total number of subscribers to and total number of subscriber months for each Covered Service operated or authorized by such Participating RIAA Member during the reporting period; provided that any such information relating to a Covered Service operated by a Participating RIAA Member shall be subject to an appropriate confidentiality restriction, and any such information provided to a Participating RIAA Member by a third party shall be subject to any applicable confidentiality and other contractual use restrictions. Notwithstanding the foregoing, to the extent that information requested by HFA under this Section 6.2 is subject to existing, proposed or future confidentiality restrictions that would preclude its disclosure to HFA, the relevant Participating RIAA Member shall in good faith seek the consent of the party that is the source of such information to disclose such information to HFA, subject to appropriate confidentiality restrictions.

7. Term. The term of this Agreement shall commence on the Effective Date and, subject to Sections 4.2 and 8.5, continue until the final non-appealable determination of royalty rates for each of On-Demand Streams and Limited Downloads through negotiation and/or a CARP proceeding. New Licenses shall continue to be issued pursuant to this Agreement for the duration of such term. Thereafter, RIAA member companies may request, and HFA shall issue, mechanical licenses covering On-Demand Streams and Limited Downloads at the applicable royalty rates in accordance with its customary practices for the issuance of licenses where there is an applicable statutory rate, which the Parties currently understand to include the means of application described in Section 3.1. Notwithstanding the foregoing, Licenses once issued under this arrangement shall remain in effect unless terminated for default in respect to payment (once royalty rates are determined) or accounting (either before or after royalty rates are determined) pursuant to 17 U.S.C. § 115(c)(6) (or other applicable provision of law, if any), it being understood that a License may not be terminated for such a default where the default is remedied as provided in 17 U.S.C. § 115(c)(6). In addition, the provisions of Sections 3.6, 4.2, 4.4 and

4.5, and of Articles 6 and 7, shall survive the expiration or termination of this Agreement or any License under this Agreement.

8. Legal Framework for Agreement.

8.1. Subject to the other provisions of this Article 8, in order to settle issues in dispute and avoid litigation, provide assurance to record companies seeking to launch digital music services and enable HFA's issuance of license forms for Covered Services hereunder:

(a) The Parties agree that under current law the process of making On-Demand Streams through Covered Services (from the making of server reproductions to the transmission and local storage of the stream), viewed in its entirety, involves the making and distribution of a DPD, and further agree that such process in its entirety (i.e., inclusive of any server reproductions and any temporary or cached reproductions through to the transmission recipient of the On-Demand Stream) is subject to the compulsory licensing provisions of Section 115 of the Copyright Act. The Parties further agree that under current law the process of making streams that would qualify for a statutory license under Section 114(d)(2) of the Copyright Act does not involve the making or distribution of a DPD, and thus does not require a mechanical license. The foregoing does not express or imply any agreement that, and shall not be used to support any argument that, the process of making On-Demand Streams other than through Covered Services, or the process of making streams that would not qualify for a statutory license under Section 114(d)(2) of the Copyright Act (including, without limitation, because such streams are part of an "interactive service" (as that term is defined in Section 114(j)(7)) or exceed the "sound recording performance complement" (as that term is defined in Section 114(j)(13)) does or does not involve the making and distribution of a DPD, and the Parties expressly reserve all their rights with respect to that issue.

(b) The Parties agree that under current law the process of making Limited Downloads through Covered Services (from the making of server reproductions to the transmission and local storage of the Limited Download), viewed in its entirety, involves the making and distribution of a DPD, and further agree that such process in its entirety (*i.e.*, inclusive of any server reproductions and any temporary or cached reproductions through to the transmission recipient of the Limited Download) is subject to the compulsory licensing provisions of Section 115 of the Copyright Act.

(c) The Parties agree that under current law a compulsory license to make On-Demand Streams and Limited Downloads through Covered Services (from the making of server reproductions to the transmission and local storage of the On-Demand Streams and Limited Downloads) is available under Section 115 of the Copyright Act.

8.2. Subject to Sections 8.3 and 8.5, for the term of this Agreement, no Party, no Participating RIAA Member and no Participating NMPA/HFA Publisher shall take a position contrary to or inconsistent with Section 8.1, or lend support or resources, financial or otherwise, to any other person or entity taking a contrary or inconsistent position, before the Copyright Office, a CARP, a court or any other government office or tribunal. Thereafter, no Party, no Participating RIAA Member and no Participating NMPA/HFA Publisher shall commence or lend support to any action in court to challenge the validity of the rates determined pursuant to

Article 5 on the ground that On-Demand Streams and Limited Downloads do not involve the making or distribution of DPDs. It is understood that, for purposes of this Section 8.2, a Participating RIAA Member or Participating NMPA/HFA Publisher shall not be deemed to lend financial support or resources to affiliated entities merely through intra-enterprise financial arrangements in the ordinary course of business.

8.3. Notwithstanding Sections 8.1 and 8.2, the Parties, Participating RIAA Members and Participating NMPA/HFA Publishers may at any time (1) raise and litigate (including, without limitation, before a CARP) the economic value of, and the appropriate royalty rates to be applied to, On-Demand Streams and Limited Downloads; (2) take or support any position they choose with respect to sound recordings (as distinguished from any musical works embodied therein) and the rights therein, including, without limitation, rights under Sections 106 and 114 of the Copyright Act, and (3) make or lend support to any arguments they choose to prosecute, or defend or counterclaim against, an infringement claim relating to activities before the Effective Date. Notwithstanding Sections 8.1 and 8.2, RIAA and Participating RIAA Members may at any time make or lend support to any arguments they choose to defend or counterclaim against an infringement claim relating to activities on or after the Effective Date, in the event that a License with respect to the relevant works is not available hereunder (it being understood that, subject to Section 8.4, NMPA, HFA and Participating NMPA/HFA Publishers may participate in the litigation of any such claim, so long as their doing so is consistent with Sections 8.1 and 8.2). The Parties agree that they will act in good faith not to induce, promote or encourage the litigation of an infringement claim relating to activities as described in the immediately preceding sentence.

8.4. To the extent that an action being litigated by RIAA and/or a Participating RIAA Member, other than that pending case in the Southern District of New York captioned *Rodgers & Hammerstein Organization v. UMG Recordings, Inc.*, involves the question of the validity of a notice of intention to obtain a compulsory license as described in Section 8.1(c) for a musical work for which a License is not available under this Agreement, neither NMPA nor HFA shall participate in or lend support to such action. The Parties agree that they will act in good faith not to induce, promote or encourage litigation concerning the validity of a notice of intention to obtain a compulsory license as described in Section 8.1(c).

8.5. To the extent that a final, non-appealable decision of the Copyright Office or a court, or any new legislation, is inconsistent with Section 8.1, this Agreement shall be inapplicable to the extent of the inconsistency as of the date thereof, but subject to Article 4, Participating RIAA Members shall not be entitled to a refund of any monies paid prior to such date.

8.6. This Agreement is entered into in settlement and compromise of certain disputes among the Parties and to clarify certain aspects of the licensing of On-Demand Streams and Limited Downloads. Nothing in this Article 8 shall be used by, or be enforceable by, a third party not a Party to this Agreement, other than a Participating RIAA Member or Participating NMPA/HFA Publisher, in any manner or in any context, including without limitation in any legal proceeding. This Agreement does not give rise to any third-party beneficiary rights in any party other than Participating RIAA Members and Participating NMPA/HFA Publishers. The agreements set forth in this Article 8 and the course of dealing hereunder shall be inadmissible, and shall not be used to support any argument of law, in any litigation or arbitration relating to

(1) activities before the Effective Date or (2) activities other than making and distributing On-Demand Streams and Limited Downloads through Covered Services, except making streams that would qualify for a statutory license under Section 114(d)(2) of the Copyright Act.

9. Copyright Office Proceedings.

9.1. RIAA and NMPA promptly shall file in the Copyright Office, in the Mechanical and Digital Phonorecord Delivery Compulsory License rulemaking proceeding (docket number 2000-7) (the "Proceeding"), an appropriate mutually agreeable document (the "Joint Statement") signed by representatives of both RIAA and NMPA and (1) explaining that they have entered into this Agreement to resolve certain differences between them and enable the expeditious launch of subscription music services; and (2) describing the material terms of this Agreement (including without limitation the agreement in Section 8.1). Unless the Parties agree otherwise, the Joint Statement shall not address the question of whether the Copyright Office should or should not proceed with the Proceeding, and none of the Parties shall use the existence of the Agreement to argue to the Copyright Office that the Office should or should not proceed with the Proceeding.

9.2. Either in the Joint Statement, in joint comments submitted in response to the Copyright Office's Notice of Proposed Rulemaking dated August 28, 2001, or in a separate petition signed by representatives of both Parties to be filed in the Copyright Office promptly after the Effective Date, RIAA and NMPA shall request that the Copyright Office amend 37 C.F.R. § 201.18 to facilitate the licensing process for digital music services by addressing in a mutually agreeable manner such procedural issues as:

(a) Permitting combined notices of intention;

(b) Permitting service of notices of intention on the copyright owner's agent, and designating HFA as agent for the receipt of such notices;

(c) Eliminating the requirement that officer/director information be provided for publicly traded companies and their subsidiaries;

(d) Permitting notices of intention to be signed by any authorized representative of the licensee;

(e) Permitting mailing to a known correct address of the copyright owner; and

(f) Permitting the service of notices of intention by regular mail.

10. Congress. As soon as practicable after the Effective Date, and before any relevant congressional hearings then scheduled, if possible, the Parties shall draft and submit a mutually agreeable letter to appropriate members of Congress describing this Agreement and the benefits thereof.

11. Memoranda of Understanding. Promptly after the Effective Date, HFA and RIAA shall commence good-faith negotiations to (1) revise and renew for an additional year the

Memorandum of Understanding dated September 21, 2000 (the "MOU") concerning interim licenses for DPDs, the revisions to address updated licensing procedures consistent with the licensing procedures to be implemented under this Agreement, and (2) enter into a second Memorandum of Understanding concerning certain licensing, payment and additional operational issues of mutual concern to HFA and RIAA members, which issues shall include:

(a) record companies' payment to HFA of 100% of royalties due for a particular musical work regardless of whether HFA acts as an agent for all owners of such work;

(b) record companies' provision of album label copy to HFA in order to facilitate the licensing process; and

(c) what information concerning publisher names and shares appropriately should be provided by HFA to Participating RIAA Members, and the appropriate confidentiality protections therefor.

Pending completion of such negotiations, HFA will continue to issue "Interim DPD Licenses" as described in the MOU in accordance with the practice that has developed under the MOU.

12. Economic Data. In order to help the Parties better understand and evaluate emerging business models for digital music services, RIAA and NMPA shall jointly hire an independent accounting firm to collect from Participating RIAA Members on a confidential basis information concerning the economics of emerging subscription service business models and report composite information to RIAA and NMPA for the duration of this Agreement.

13. Security. If RIAA or any Participating RIAA Member learns of any substantial (in terms of number of musical works affected, number of copies or prevalence) circumvention of security measures used by Covered Services resulting in unauthorized copying or distribution of sound recordings of musical works by authorized or unauthorized users of Covered Services, RIAA and/or the Participating RIAA Member shall use commercially reasonable efforts promptly to notify HFA of such unauthorized activity; provided, however, that RIAA and Participating RIAA Members shall be liable for damages for breach of this Article 13 only if, and to the extent, that they themselves are liable for direct, contributory or vicarious copyright infringement under applicable U.S. law, and in such case such damages shall be only those payable for such infringement.

14. Electronic Reporting. The Parties agree to work together in good faith to implement means whereby accounting information relating to Licenses will be provided to HFA in electronic, machine-readable form.

15. Publicity. RIAA and NMPA will issue a joint press release announcing this arrangement. In their communications to their members concerning this Agreement, the Parties shall recommend that their members avail themselves of this Agreement. The Parties confirm that, subject to Section 8.6, this Agreement is not confidential.

16. Miscellaneous.

16.1. Governing Law. This Agreement shall be governed by, and construed in accordance with, the laws of the State of New York (without giving effect to conflicts of law principles thereof).

16.2. Amendment. This Agreement may be modified or amended only by a writing signed by each of the Parties.

16.3. Entire Agreement. This Agreement expresses the entire understanding of the Parties and supersedes all prior and contemporaneous agreements and undertakings of the Parties with respect to the subject matter hereof.

16.4. No Effect on Other Agreements. Without limitation, this Agreement shall not terminate, supersede, limit or otherwise affect the enforceability of, or the rights of any of the respective parties to, any of the following agreements: (1) the Settlement Agreement dated as of October 17, 2000 between HFA, MPL Communications, Inc. and Peer International Corporation, on the one hand, and MP3.com, Inc., on the other, and any amendments thereto; (2) the Governing Agreement dated as of October 2000 between HFA, MPL Communications, Inc. and Peer International Corporation, on the one hand, and MP3.com, Inc., on the other, and any amendments thereto; (3) the Digital Phonorecord Delivery License dated January 15, 1999 between HFA and Emusic.com Inc., and any amendments thereto; and (4) the Amendment Agreement dated November 2000 between HFA and Emusic.com Inc., and any amendments thereto.

16.5. Counterparts. This Agreement may be executed in counterparts, including by means of facsimile, each of which shall be deemed to be an original, but which taken together shall constitute one agreement.

16.6. Headings. The titles used in this Agreement are used for convenience only and are not to be considered in construing or interpreting this Agreement.

IN WITNESS WHEREOF, the Parties have executed this Agreement as of the Effective Date.

Edward P. Murphy
President and CEO, NMPA

Hilary B. Rosen
President and CEO, RIAA

Gary Churgin
President and CEO HFA

Cary Sherman
Senior Executive Vice President
and General Counsel, RIAA

HFA/RIAA Electronic License Request & Output File Layout

Acceptable Data Formats:

1. *MS Access database*
2. *MS Excel Spreadsheets (with proper headings)*
3. *Flat File (follow the file layout below)*

	Description	Type	Length	Decimal	Input Option
1	Manufacturer Number	A	6		M
2	Transaction Date	N	8	0	M
3	Manufacturer Request Number	N	8	0	M
4	Label Name	A	15		M
5	ISRC Code	A	15		M
6	Playing Time - Minutes	N	3	0	M
7	Playing Time - Seconds	N	2	0	M
8	Artist	A	200		M
9	Song Title	A	200		M
10	A/K/A Song Title	A	200		O
11	ISWC Code	A	11		O
12	HFA Song Code	A	6		O
13	Song Writer(s)	A	200		C*
14	Publisher Name	A	60		C*
15	HFA Publisher Number	A	6		O
16	Publisher Share	N	7	4	O
17	Catalog Number	A	15		C*
18	Album (physical product) Title	A	200		C*
19	UPC Code	A	16		C*
20	Configuration Code	A	2		M
21	License Type	A	1		M
22	Server Fixation Date	N	8	0	M
23	Rate Code	A	1		C**
24	Rate In Cents	N	7	7	C**
25	Rate In Percentage of Statutory	N	5	2	C**
26	Rate In Percentage of Minimum Statutory	N	5	2	C**
27	HFA License Number	N	10		*Output*
28	HFA License Reject Code	A	2		*Output*
29	HFA Flag for Amended Publisher Data	A	1		*Output*

KEY:

TYPE:
A = Alphanumeric Field
N = Numeric Field

LENGTH: For Alphanumeric fields, it is the maximum number of characters required.
For Numeric fields, it is the exact number of characters required

DECIMAL: Number of characters after decimal (for numeric fields only)

INPUT OPTION:
M = Mandatory
O = Optional
C* = Conditional — As agreed, label must provide either: (a) Songwriter or (b) Publisher, Catalog Number, Album Title and UPC. If (a) is provided, then (b) is not required; and vice versa.
C** = Conditional — One of the rate code fields from 23-26 must be completed

HFA/RIAA Electronic License Request & Output File Layout: Field Explanations

	Field	Type: M=Mandatory O=Optional C=Conditional	Explanation	Example
1	Manufacturer Number	M	Account number assigned by HFA to Licensee	M12345
2	Transaction Date	M	Date electronic license request submitted to HFA	Format: YYYYMMDD Example: 3/4/2001 Data Entered: 20010304
3	Manufacturer Request Number	M	Unique identifying number (numerical only) assigned by Licensee for each work for which a license is requested	12345678
4	Label Name	M	The name of the record label that produced the applicable recording	Epic
5	ISRC Code	M	*International Standard Recording Code.* ISRC code assigned to the recording by the record label.	USSM19804780
6	Playing Time - Minutes	M	The number of minutes in the duration of the applicable recording	Duration = 5 minutes and 52 seconds Data entered: 005
7	Playing Time – Seconds	M	The number of seconds over the last full minute in the duration of the applicable recording	Duration = 5 minutes and 52 seconds Data entered: 52
8	Artist	M	The name of the artist performing the applicable recording	John Lennon, Paul McCartney
9	Song Title	M	Title of work for which a License is requested	Yesterday
10	A/K/A Song Title	O	Other names by which the work is known	Over the Rainbow; Somewhere Over the Rainbow
11	ISWC Code	O	*International Standard Musical Work Code.* Code assigned to works by the network of ISO/ISWC Local or Regional agencies	Example: T-034.524.680-1 Data Entered: T0345246801
12	HFA Song Code	O	Identifier assigned by HFA to identify a work uniquely	Example: P12345
13	Songwriter(s)	C *Provide either: (a) Songwriter or (b) Publisher, Catalog #, Album Title and UPC*	Name of the composer(s) of the work.	Format: [First Name] [Last Name], [First Name], etc Example: Michael Ross, Tom Smith

14	**Publisher Name**	C *Provide either: (a) Songwriter or (b) Publisher, Catalog #, Album Title and UPC*	Name of publisher owning a share of the work. Additional publishers should be listed on separate lines using the same manufacturer's request number assigned to the work.	EMI Mills	
15	**HFA Publisher Number**	O	Identifier assigned by HFA to identify a publisher uniquely.	P12345	
16	**Publisher Share**	O	Percent of song owned by publisher.	Example: 66.667% Data Entered: 066.6670	
17	**Catalog Number**	C *Provide either: (a) Songwriter or (b) Publisher, Catalog #, Album Title and UPC*	The catalog number of a prior physical product that has been previously licensed (where applicable.)	12345-2	
18	**Album (physical product) Title**	C *Provide either: (a) Songwriter or (b) Publisher, Catalog #, Album Title and UPC*	The title of a prior physical product that has been previously licensed (where applicable)	Parachute	
19	**UPC Code**	C *Provide either: (a) Songwriter or (b) Publisher, Catalog #, Album Title and UPC*	The UPC code of a prior physical product that has been previously licensed (where applicable).	706301594728	
20	**Configuration Code**	M	Code designating configuration type(s) applicable. Numerous options available; most relevant are in example column.	CV	Use in Covered Services under this Agreement (includes LT, LU and S below)
				LT	*Time-Limited Digital Phonorecord Delivery*
				LU	*Use Limited Digital Phonorecord Delivery*
				S	*On-Demand Streaming (Single)*
				SF	Digital Phonorecord Delivery (Single)
21	**License Type**	M	Classification of license type requested. Numerous options available; most relevant is in example column.	E	Digital
22	**Server Fixation Date**	M	The date the applicable recording was or is expected to be fixed to the server for distribution via streaming or downloading.	Format: YYYYMMDD Example: 3/4/2001 Data Entered: 20010304	

23	Rate Code	C *(one of the rate fields from 23 – 26 must be completed)*	Code designating type of rate applicable. Numerous options available; most relevant are in example column.	T	Statutory rate to be determined under this Agreement
				R	Under controlled composition clause in contract where controlled rate applies
				S	Statutory (already determined)
24	Rate in Cents	C *(one of the rate fields from 23 – 26 must be completed)*	Rate indicated as a penny rate.	.0755000	
25	Rate in Percentage of Statutory	C *(one of the rate fields from 23 – 26 must be completed)*	Rate indicated in percentage of statutory.	075.00	
26	Rate in Percentage of Minimum Statutory	C *(one of the rate fields from 23 – 26 must be completed)*	Rate indicated in a percentage of minimum statutory.	075.00	
27	HFA License Number	Output	Number assigned by HFA for each license	1010120001	
28	HFA License Reject Code	Output	Code designating reason why request was not licensable as submitted. Numerous options available; most relevant are in example column.	01	NO MATCH FOUND (FOR OTHER THAN SPECIFICALLY LISTED REJECT CODES)
				02	DUPLICATE LICENSE REQUEST (1ST PASS - PRELIMINARY SCAN; WITHIN THE CURRENT BATCH)
				03	DUPLICATE LICENSE REQUEST (2ND PASS, ALREADY LICENSED, PART OF EDIT VALIDATION PROCESS)
				10	SONG TITLE NOT FOUND
				11	SONG TITLE MATCH ONLY, INSUFFICIENT FOR LICENSE
				12	SONG TITLE AND ARTIST MATCH ONLY, INSUFFICIENT FOR LICENSE
				13	SONG TITLE AND ALBUM MATCH ONLY, INSUFFICIENT FOR LICENSE
				14	SONG TITLE AND CATALOG / UPC # MATCH ONLY, INSUFFICENT FOR LICENSE

				21	CONTROLLED RATE REQUEST COULD NOT BE MATCHED TO PREVIOUSLY
				81	PUBLISHER NOT REPRESENTED BY HARRY FOX AGENCY
				82	PUBLISHER UNKNOWN
				83	PUBLISHER OPTED-OUT OF AGREEMENT
				91	ORIGINAL VERSION OF SONG IS IN THE PUBLIC DOMAIN IN THE USA
				92	PUBLISHER OWNERSHIP NOT YET VERIFIED
				93	SONG PLACED ON HOLD FOR LICENSING BY PUBLISHER
				94	SONG HAS RESTRICTIONS; REQUIRES PUBLISHER APPROVAL
				95	OLD DERIVATIVE VERSION OF SONG, CURRENT PUBLISHER UNKNOWN
				96	INVALID SONG CODE
29	**HFA Flag for Amended Publisher Data**	Output	Indicates that publisher information submitted by licensee differs on HFA database (for HFA represented publishers only)	Y	Flagged so that requestor can note that HFA publisher information differs from that submitted

EXHIBIT CO 0753

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Digital Albums & Tracks

Week Ending	2003 Digital Albums	2003 Digital Tracks
1/5/2003		
1/12/2003		
1/19/2003		
1/26/2003		
2/2/2003		
2/9/2003		
2/16/2003		
2/23/2003		
3/2/2003		
3/9/2003		
3/16/2003		
3/23/2003		
3/30/2003		
4/6/2003		
4/13/2003		
4/20/2003		
4/27/2003		
5/4/2003		
5/11/2003		
5/18/2003		
5/25/2003		
6/1/2003		
6/8/2003		
6/15/2003		
6/22/2003		
6/29/2003		303,000
7/6/2003		328,000
7/13/2003		298,000
7/20/2003		300,000
7/27/2003		311,000
8/3/2003		324,000
8/10/2003		326,000
8/17/2003		269,000

8/24/2003	338,000
8/31/2003	381,000
9/7/2003	452,000
9/14/2003	427,000
9/21/2003	480,000
9/28/2003	468,000
10/5/2003	443,000
10/12/2003	406,000
10/19/2003	684,000
10/26/2003	857,000
11/2/2003	827,000
11/9/2003	1,001,000
11/16/2003	1,171,000
11/23/2003	1,514,000
11/30/2003	1,271,000
12/7/2003	1,224,000
12/14/2003	1,317,000
12/21/2003	1,487,000
12/28/2003	1,745,000

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Digital Albums & Tracks

Week Ending	2004 Digital Albums	2004 Digital Tracks
1/4/2004		1,692,000
1/11/2004		1,652,000
1/18/2004		1,702,000
1/25/2004		1,778,000
2/1/2004		1,741,000
2/8/2004		1,975,000
2/15/2004		2,116,000
2/22/2004		2,061,000
2/29/2004		2,022,000
3/7/2004		1,983,000
3/14/2004		2,015,000
3/21/2004		2,145,000
3/28/2004		2,155,000
4/4/2004		2,121,000
4/11/2004		2,027,000
4/18/2004		1,982,000
4/25/2004		2,008,000
5/2/2004		2,170,000
5/9/2004		2,159,000
5/16/2004		2,090,000
5/23/2004		2,334,000
5/30/2004		2,396,000
6/6/2004		2,307,000
6/13/2004		2,149,000
6/20/2004		2,455,000
6/27/2004		2,600,000
7/4/2004	82,000	2,593,000
7/11/2004	88,000	2,719,000
7/18/2004	84,000	2,712,000
7/25/2004	85,000	2,600,000
8/1/2004	94,000	2,867,000
8/8/2004	83,000	2,754,000
8/15/2004	80,000	2,564,000

8/22/2004	121,000	2,934,000
8/29/2004	133,000	3,046,000
9/5/2004	143,000	3,123,000
9/12/2004	119,000	3,005,000
9/19/2004	120,000	3,210,000
9/26/2004	139,000	2,785,000
10/3/2004	142,000	2,836,000
10/10/2004	144,000	2,950,000
10/17/2004	146,000	3,017,000
10/24/2004	144,000	3,112,000
10/31/2004	150,000	3,207,000
11/7/2004	145,000	3,137,000
11/14/2004	158,000	3,381,000
11/21/2004	179,000	3,472,000
11/28/2004	208,000	3,647,000
12/5/2004	180,000	3,508,000
12/12/2004	189,000	3,858,000
12/19/2004	197,000	3,988,000
12/26/2004	227,000	5,046,000

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Digital Albums & Tracks

Week Ending	2005 Digital Albums	2005 Digital Tracks
1/2/2005	258,000	6,690,000
1/9/2005	238,000	5,448,000
1/16/2005	215,000	5,247,000
1/23/2005	226,000	5,247,000
1/30/2005	201,000	4,700,000
2/6/2005	238,000	5,538,000
2/13/2005	220,000	5,653,000
2/20/2005	270,000	6,160,000
2/27/2005	233,000	5,938,000
3/6/2005	256,000	6,067,000
3/13/2005	236,000	6,273,000
3/20/2005	217,000	6,355,000
3/27/2005	223,000	6,419,000
4/3/2005	262,000	7,111,000
4/10/2005	230,000	6,358,000
4/17/2005	229,000	6,613,000
4/24/2005	239,000	6,386,000
5/1/2005	229,000	5,849,000
5/8/2005	264,000	6,416,000
5/15/2005	284,000	6,493,000
5/22/2005	274,000	6,740,000
5/29/2005	274,000	6,590,000
6/5/2005	251,000	5,999,000
6/12/2005	351,000	6,244,000
6/19/2005	292,000	6,253,000
6/26/2005	262,000	6,063,000
7/3/2005	280,000	6,585,000
7/10/2005	290,000	6,585,000
7/17/2005	273,000	6,349,000
7/24/2005	258,000	6,157,000
7/31/2005	271,000	6,175,000
8/7/2005	298,000	6,820,000
8/14/2005	290,000	6,575,000
8/21/2005	303,000	6,687,000

8/28/2005	270,000	6,024,000
9/4/2005	398,000	7,242,000
9/11/2005	318,000	6,340,000
9/18/2005	363,000	6,799,000
9/25/2005	351,000	6,752,000
10/2/2005	376,000	6,945,000
10/9/2005	399,000	7,079,000
10/16/2005	390,000	6,441,000
10/23/2005	403,000	6,668,000
10/30/2005	365,000	6,816,000
11/6/2005	353,000	6,434,000
11/13/2005	441,000	8,114,000
11/20/2005	399,000	7,192,000
11/27/2005	367,000	7,830,000
12/4/2005	413,000	7,225,000
12/11/2005	440,000	7,435,000
12/18/2005	433,000	7,729,000
12/25/2005	531,000	9,563,000

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Digital Album & Tracks

Week Ending	2006 Digital Albums	2006 Digital Tracks
1/1/2006	768,000	19,906,000
1/8/2006	615,000	13,402,000
1/15/2006	453,000	9,952,000
1/22/2006	534,000	11,650,000
1/29/2006	584,000	11,139,000
2/5/2006	578,000	10,970,000
2/12/2006	612,000	10,858,000
2/19/2006	606,000	11,611,000
2/26/2006	602,000	11,453,000
3/5/2006	556,000	10,369,000
3/12/2006	591,000	10,973,000
3/19/2006	542,000	10,533,000
3/26/2006	563,000	10,698,000
4/2/2006	551,000	10,342,000
4/9/2006	574,000	10,242,000
4/16/2006	539,000	10,074,000
4/23/2006	527,000	10,620,000
4/30/2006	559,000	10,242,000
5/7/2006	559,000	10,027,000
5/14/2006	565,000	9,495,000
5/21/2006	591,000	10,891,000
5/28/2006	601,000	10,645,000
6/4/2006	547,000	10,820,000
6/11/2006	579,000	10,823,000
6/18/2006	581,000	10,894,000
6/25/2006	575,000	11,038,000
7/2/2006	627,000	11,222,000
7/9/2006	541,000	10,474,000
7/16/2006	561,000	10,022,000
7/23/2006	529,000	9,813,000
7/30/2006	576,000	10,917,000
8/6/2006	567,000	10,726,000
8/13/2006	558,000	10,486,000
8/20/2006	587,000	10,673,000

8/27/2006	613,000	10,854,000
9/3/2006	642,000	10,782,000
9/10/2006	617,000	10,349,000
9/17/2006	887,000	12,197,000
9/24/2006	711,000	10,179,000
10/1/2006	699,000	10,107,000
10/8/2006		
10/15/2006		
10/22/2006		
10/29/2006		
11/5/2006		
11/12/2006		
11/19/2006		
11/26/2006		
12/3/2006		
12/10/2006		
12/17/2006		
12/24/2006		
12/31/2006		

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EXHIBITS CO 0754 – CO 0900

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