
**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

Form 10-Q

(Mark One)

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

For the quarterly period ended June 28, 2003 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 0-10030

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 an accelerated filer (as defined in Exchange Act Rule 12b-2).

Yes No

362,500,925 shares of Common Stock Issued and Outstanding as of August 1, 2003

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		Nine Months Ended	
	June 28, 2003	June 29, 2002	June 28, 2003	June 29, 2002
Net sales	\$ 1,545	\$ 1,429	\$ 4,492	\$ 4,299
Cost of sales	1,117	1,038	3,240	3,077
Gross margin	428	391	1,252	1,222
Operating expenses:				
Research and development	120	106	360	330
Selling, general, and administrative	299	272	898	831
Restructuring costs	—	—	26	24
Total operating expenses	419	378	1,284	1,185
Operating income (loss)	9	13	(32)	37
Gains on non-current investments, net	2	—	2	23
Interest and other income, net	15	26	67	87
Total interest and other income, net	17	26	69	110
Income before provision for income taxes	26	39	37	147
Provision for income taxes	7	7	10	37
Income before accounting change	19	32	27	110
Cumulative effect of accounting change, net of income taxes of \$1	—	—	(2)	—
Net income	\$ 19	\$ 32	\$ 25	\$ 110
Earnings per common share before accounting change:				
Basic	\$ 0.05	\$ 0.09	\$ 0.07	\$ 0.31
Diluted	\$ 0.05	\$ 0.09	\$ 0.07	\$ 0.30
Earnings per common share after accounting change:				
Basic	\$ 0.05	\$ 0.09	\$ 0.07	\$ 0.31
Diluted	\$ 0.05	\$ 0.09	\$ 0.07	\$ 0.30
Shares used in computing earnings per share (in thousands):				
Basic	360,793	356,370	360,113	353,800
Diluted	363,777	366,882	362,421	363,438

See accompanying notes to condensed consolidated financial statements.

APPLE COMPUTER, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS (Unaudited)
(in millions, except share amounts)

	June 28, 2003	September 28, 2002
ASSETS:		
Current assets:		
Cash and cash equivalents	\$ 3,507	\$ 2,252
Short-term investments	1,038	2,085
Accounts receivable, less allowances of \$49 and \$51, respectively	568	565
Inventories	38	45
Deferred tax assets	176	166
Other current assets	219	275
Total current assets	5,546	5,388
Property, plant and equipment, net	639	621
Goodwill	85	85
Acquired intangible assets	27	34
Other assets	144	170
Total assets	<u>\$ 6,441</u>	<u>\$ 6,298</u>
LIABILITIES AND SHAREHOLDERS' EQUITY:		
Current liabilities:		
Accounts payable	\$ 880	\$ 911
Accrued expenses	838	747
Current debt	307	—
Total current liabilities	2,025	1,658
Long-term debt	—	316
Deferred tax liabilities and other non-current liabilities	218	229
Total liabilities	2,243	2,203
Commitments and contingencies		
Shareholders' equity:		
Common stock, no par value; 900,000,000 shares authorized; 366,992,631 and 358,958,989 shares issued and outstanding, respectively	1,935	1,826
Deferred stock compensation	(68)	(7)
Retained earnings	2,350	2,325
Accumulated other comprehensive income (loss)	(19)	(49)
Total shareholders' equity	4,198	4,095
Total liabilities and shareholders' equity	<u>\$ 6,441</u>	<u>\$ 6,298</u>

See accompanying notes to condensed consolidated financial statements.

APPLE COMPUTER, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)
(in millions)

	Nine Months Ended	
	June 28, 2003	June 29, 2002
Cash and cash equivalents, beginning of the period	\$ 2,252	\$ 2,310
Operating Activities:		
Net income	25	110
Cumulative effect of accounting change, net of taxes	2	—
Adjustments to reconcile net income to cash generated by operating activities:		
Depreciation, amortization and accretion	93	85
Non-cash restructuring	12	4
Provision for (benefit from) deferred income taxes	(16)	(2)
Loss on disposition of property, plant, and equipment	2	6
Gains on sales of short-term investments, net	(21)	(5)
Gains on sales of non-current investments, net	(2)	(23)
Changes in operating assets and liabilities:		
Accounts receivable	(3)	(160)
Inventories	7	(23)
Other current assets	56	(154)
Other assets	(15)	(13)
Accounts payable	(31)	103
Other current liabilities	107	79
Cash generated by operating activities	<u>216</u>	<u>7</u>
Investing Activities:		
Purchase of short-term investments	(1,981)	(3,478)
Proceeds from maturities of short-term investments	1,954	1,917
Proceeds from sale of short-term investments	1,072	519
Proceeds from sale of non-current investments	36	25
Purchases of property, plant, and equipment	(106)	(110)
Other	33	(33)
Cash generated by (used for) investing activities	<u>1,008</u>	<u>(1,160)</u>
Financing Activities:		
Proceeds from issuance of common stock	31	89
Cash generated by financing activities	<u>31</u>	<u>89</u>
Increase (decrease) in cash and cash equivalents	1,255	(1,064)
Cash and cash equivalents, end of the period	<u>\$ 3,507</u>	<u>\$ 1,246</u>
Supplemental cash flow disclosures:		
Cash paid for interest	\$ 10	\$ 10
Cash paid for income taxes, net	\$ 35	\$ 8

See accompanying notes to condensed consolidated financial statements.

APPLE COMPUTER, INC.

Notes to Condensed Consolidated Financial Statements (Unaudited)

Note 1 - Summary of Significant Accounting Policies

Apple Computer, Inc. and its subsidiaries (the Company) designs, manufactures, and markets personal computers and related personal computing and communicating solutions for sale primarily to education, creative, consumer, and business 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. Interim information is unaudited; however, in the opinion of the Company's management, all adjustments of a normal recurring nature necessary for a fair statement of interim periods presented have been included. The results for interim periods are not necessarily indicative of results to be expected for the entire year.

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 28, 2002, included in its Annual Report on Form 10-K for the year ended September 28, 2002 (the 2002 Form 10-K). 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.

Accounting for Asset Retirement Obligations

On September 29, 2002, the Company adopted Statement of Financial Accounting Standards (SFAS) No. 143, *Accounting for Asset Retirement Obligations*, which addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. The standard applies to legal obligations associated with the retirement of long-lived assets that result from the acquisition, construction, development and/or normal use of the assets. SFAS No. 143 requires that the fair value of a liability for an asset retirement obligation be recognized in the period in which it is incurred if a reasonable estimate of fair value can be made. The fair value of the liability is added to the carrying amount of the associated asset and this additional carrying amount is depreciated over the life of the asset. All of the Company's existing asset retirement obligations are associated with commitments to return property subject to operating leases to original condition upon lease termination. The Company estimated that as of September 29, 2002, gross expected future cash flows of \$9.5 million would be required to fulfill these obligations.

As of the date of adoption, the Company recorded a \$6 million long-term asset retirement liability and a corresponding increase in leasehold improvements. This amount represents the present value of expected future cash flows associated with returning certain of the Company's leased properties to original condition. The difference between the gross expected future cash flow of \$9.5 million and its present value at September 29, 2002, of \$6 million will be accreted over the life of the related leases as an operating expense. Net of the related income tax effect of approximately \$1 million, adoption of SFAS No. 143 resulted in an unfavorable cumulative-effect type adjustment to net income during the first quarter of 2003 of approximately \$2 million. This adjustment represents cumulative depreciation and accretion that would have been recognized through the date of adoption of SFAS No. 143 had the statement been applied to the Company's existing asset retirement obligations at the time they were initially incurred.

The following table reconciles changes in the Company's asset retirement liability for the first nine months of 2003 (in millions):

Asset retirement liability recorded at 9/29/02	\$	5.5
Additional asset retirement obligations recognized		0.3
Accretion recognized		1.1
Asset retirement liability as of 6/28/03	\$	<u>6.9</u>

Accounting for Restructuring Charges

In June 2002, the Financial Accounting Standards Board issued SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*. SFAS No. 146 supersedes Emerging Issues Task Force (EITF) Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs To Exit an Activity (Including Certain Costs Associated with a Restructuring)* and requires that a liability for a cost associated with an exit or disposal activity be recognized when the liability is incurred, as opposed to when management is committed to an exit plan. SFAS No. 146 also establishes that the liability should initially be measured and recorded at fair value. This Statement was effective for exit or disposal activities initiated after December 31, 2002. The provisions of SFAS No. 146 were required to be applied prospectively after the adoption date to newly initiated exit activities.

Stock-Based Compensation

The Company measures compensation expense for its employee stock-based compensation plans using the intrinsic value method prescribed by Accounting Principles Board (APB) Opinion 25, *Accounting for Stock Issued to Employees*, and has provided pro forma disclosures of the effect on net income and earnings per share as if the fair value-based method had been applied in measuring compensation expense. The Company has elected to follow APB No. 25 because, as discussed below, the alternative fair value accounting provided for under SFAS No. 123, *Accounting for Stock-Based Compensation*, requires use of option valuation models that were not developed for use in valuing employee stock options and employee stock purchase plan shares. Under APB No. 25, when the exercise price of the Company's employee stock options equals the market price of the underlying stock on the date of the grant, no compensation expense is recognized.

As required under SFAS No. 123, the pro forma effects of stock-based compensation on net income and earnings per common share for employee stock options granted and employee stock purchase plan purchases have been estimated at the date of grant and beginning of the period, respectively, using a Black-Scholes option pricing model. For purposes of pro forma disclosures, the estimated fair value of the options and shares is amortized to pro forma net income over the options' vesting period and the shares' plan period.

The Black-Scholes option valuation model was developed for use in estimating the fair value of freely 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 life of options and the Company's expected stock price volatility. Because the Company's employee stock options and employee stock purchase plan shares have characteristics significantly different from those of freely traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not provide a reliable measure of the fair value of the Company's employee stock options and employee stock purchase plan shares.

For purposes of the pro forma disclosures provided pursuant to SFAS No. 123, the expected volatility assumptions used by the Company prior to the third quarter of 2003 have been based solely 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. Beginning in the third quarter of 2003, the Company has modified this approach to consider other relevant factors including implied volatility in market traded options on the Company's common stock and the impact of unusual fluctuations not reasonably expected to recur on the historical volatility of the Company's common stock. The Company will continue to monitor these and other relevant factors in developing the expected volatility assumption used to value future awards.

Beginning in the third quarter of 2003, the Company shortened its estimate of the expected life of new options granted to its employees from 4 years to 3.5 years. The Company bases its expected life assumption on its historical experience and on the terms and conditions of the stock options it grants to employees. The change in the expected life assumption made during the third quarter of 2003 was the result of the expected impact of shortening the contractual life of new options granted to employees from 10 years to 7 years and changing the vesting provisions of new options granted to employees from 4 year straight-line annual vesting to 4 year straight-line quarterly vesting.

For purposes of pro forma disclosures, the estimated fair value of the options and shares is amortized to pro forma net income over the options' vesting period and the shares' plan period. The Company's pro forma information for the three and nine month periods ended June 28, 2003 and June 29, 2002 follows (in millions, except per share amounts):

	Three Months Ended		Nine Months Ended	
	6/28/03	6/29/02	6/28/03	6/29/02
Net income - as reported	\$ 19	\$ 32	\$ 25	\$ 110
Add: Stock-based employee compensation expense included in reported net income, net of tax	6	—	6	—
Deduct: Stock-based employee compensation expense determined under the fair value based method for all awards, net of tax	(40)	(60)	(141)	(185)
Net loss - pro forma	\$ (15)	\$ (28)	\$ (110)	\$ (75)
Net income per common share - as reported				
Basic	\$ 0.05	\$ 0.09	\$ 0.07	\$ 0.31
Diluted	\$ 0.05	\$ 0.09	\$ 0.07	\$ 0.30
Net loss per common share - pro forma				
Basic	\$ (0.04)	\$ (0.08)	\$ (0.30)	\$ (0.21)
Diluted	\$ (0.04)	\$ (0.08)	\$ (0.30)	\$ (0.21)

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 June 28, 2003, and September 28, 2002 (in millions):

	As of 6/28/03	As of 9/28/02
Cash	\$ 174	\$ 161
U.S. Treasury and Agency securities	45	47
U.S. corporate securities	2,453	1,952
Foreign securities	835	92
Total cash equivalents	3,333	2,091
U.S. Treasury and Agency securities	358	681
U.S. corporate securities	456	988
Foreign securities	224	416
Total short-term investments	1,038	2,085
Total cash, cash equivalents, and short-term investments	\$ 4,545	\$ 4,337

The Company's short-term investment portfolio consists of investments in U.S. Treasury and Agency securities, U.S. corporate securities, and foreign securities. 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 gains on its investment portfolio of \$20 million as of September 28, 2002, and net unrealized losses of \$2 million as of June 28, 2003. The Company occasionally sells short-term investments prior to their stated maturities. As a result of such sales, the Company recognized gains of \$3 million and \$2 million during the third quarters of 2003 and 2002, respectively. Recognized gains on the sale of short-term investments were \$21 million and \$5 million during the first nine months of 2003 and 2002, respectively. These gains were included in interest and other income, net.

As of June 28, 2003, and September 28, 2002, \$338 million and \$1.087 billion, respectively, of the Company's investment portfolio that was classified as short-term investments had maturities ranging from 1 to 5 years. The remainder of the Company's short-term investments had underlying maturities of between 3 and 12 months.

Non-Current Debt and Equity Investments and Related Gains

The Company has held significant investments in ARM Holdings plc (ARM), Akamai Technologies, Inc. (Akamai) and EarthLink Network, Inc. (EarthLink). These investments have been reflected in the consolidated balance sheets as long term assets within other assets and have been categorized as available-for-sale requiring that they be carried at fair value with unrealized gains and losses, net of taxes, reported in equity as a component of accumulated other comprehensive income. All realized gains on the sale of these investments have been included in interest and other income. The combined fair value of these investments held by the Company was \$39 million as of September 28, 2002.

During the third quarter of 2003, the Company sold all of its remaining holdings in both ARM and EarthLink, consisting of 278,000 shares of ARM stock for net proceeds of approximately \$295,000, and a gain before taxes of \$270,000, and 3,960,000 shares of Earthlink stock for net proceeds of approximately \$23 million, and a gain before taxes of \$2 million. During the first quarter of 2003, the Company sold 2,580,000 shares of EarthLink stock for net proceeds of approximately \$13.7 million, an amount that approximated the Company's carrying value of the shares. As of June 28, 2003, the fair value of the Company's remaining investment in Akamai was \$14 million.

During the first quarter of 2002, the Company sold 4.7 million shares of ARM stock for both net proceeds and a gain before taxes of \$21 million. During the first quarter of 2002, the Company also sold 250,000 shares of Akamai and 117,000 shares of EarthLink stock for net proceeds of approximately \$2 million each and a gain before taxes of \$710,000 and \$223,000, respectively.

Debt

The Company currently has debt outstanding in the form of \$300 million of aggregate principal amount 6.5% unsecured notes that was originally issued in 1994. The notes, which pay interest semiannually, were sold at 99.925% of par, for an effective yield to maturity of 6.51%. The notes, along with approximately \$7 million of related unamortized deferred gains on closed interest rate swaps, are due in February of 2004 and therefore have been classified as current debt as of June 28, 2003.

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 revenues and cost of sales. From time to time, the Company enters into interest rate swap 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. As of the end of the third quarter of 2003, 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 fiscal 2002.

Foreign Exchange Risk Management

The Company enters into foreign currency forward and option contracts with financial institutions primarily to protect against foreign exchange risk associated with existing assets and liabilities, certain firmly committed transactions and certain probable but not firmly committed transactions. 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.

Interest Rate Risk Management

The Company sometimes enters into interest rate derivative transactions, including interest rate swaps, collars, and floors, with financial institutions in order to better match the Company's floating-rate interest income on its cash equivalents and short-term investments with its fixed-rate interest expense on its long-term debt, and/or to diversify a portion of the Company's exposure away from fluctuations in short-term U.S. interest rates. The Company may also

enter into interest rate contracts that are intended to reduce the cost of the interest rate risk management program. The Company does not hold or transact in such financial instruments for purposes other than risk management.

Accounting for Derivative Financial Instruments

On October 1, 2000, the Company adopted SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*. SFAS No. 133 established accounting and reporting standards for derivative instruments, hedging activities, and exposure definition. SFAS No. 133 requires that all derivatives be recognized as either assets or liabilities at fair value. Derivatives that are not hedges must be adjusted to fair value through income. 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 June 28, 2003, the Company had a net deferred loss associated with cash flow hedges of approximately \$4 million net of taxes, substantially all of which is expected to be reclassified to earnings by the end of the first quarter of fiscal 2004.

Note 3 – Condensed Consolidated Financial Statement Details (in millions)

Inventories

	<u>6/28/03</u>	<u>9/28/02</u>
Purchased parts	\$ 1	\$ 9
Work in process	—	—
Finished goods	37	36
Total inventories	\$ 38	\$ 45

Other Current Assets

	<u>6/28/03</u>	<u>9/28/02</u>
Vendor non-trade receivables	\$ 106	\$ 142
Other current assets	113	133
Total other current assets	\$ 219	\$ 275

Property, Plant, and Equipment

	<u>6/28/03</u>	<u>9/28/02</u>
Land and buildings	\$ 348	\$ 342
Machinery, equipment, and internal-use software	367	367
Office furniture and equipment	73	67
Leasehold improvements	336	281
	<u>1,124</u>	<u>1,057</u>
Accumulated depreciation and amortization	(485)	(436)
Total net property, plant, and equipment	\$ 639	\$ 621

Other Assets

	<u>6/28/03</u>	<u>9/28/02</u>
Non-current deferred tax assets	\$ 59	\$ 70
Non-current debt and equity investments	14	39
Capitalized software development costs, net	16	19
Other assets	55	42
Total other assets	\$ 144	\$ 170

Accrued Expenses

	6/28/03	9/28/02
Deferred revenue	\$ 331	\$ 253
Accrued marketing and distribution	128	136
Accrued compensation and employee benefits	117	93
Accrued warranty and related costs	67	69
Other current liabilities	195	196
Total accrued expenses	\$ 838	\$ 747

Interest and Other Income, Net

	Three Months Ended		Nine Months Ended	
	6/28/03	6/29/02	6/28/03	6/29/02
Interest income	\$ 15	\$ 29	\$ 56	\$ 92
Interest expense	(2)	(2)	(6)	(8)
Gain on sales of short term investments	3	2	21	5
Other income (expense), net	(1)	(3)	(4)	(2)
Interest and other income, net	\$ 15	\$ 26	\$ 67	\$ 87

Inventory Prepayment

In April 2002, the Company made a \$100 million prepayment to an Asian supplier for the purchase of components over the following nine months. In return for this deposit, the supplier agreed to supply the Company with a specified level of components during the three consecutive fiscal quarters ending December 28, 2002. Approximately \$53 million of this deposit remained unused as of September 28, 2002 and was reflected in the condensed consolidated balance sheets in other current assets. During the first six months of 2003, the remainder of the deposit balance was fully utilized for the purchase of components. The deposit was unsecured and had no stated interest component. The Company imputed an amount to cost of sales and interest income during each period the deposit was outstanding at a 3.25% interest rate to reflect the economics of this transaction.

Goodwill and Other Intangible Assets

The Company is currently amortizing its acquired intangible assets with definite lives over periods ranging from 3 to 7 years. The Company ceased amortization of goodwill at the beginning of fiscal 2002 when it adopted SFAS No. 142, *Goodwill and Other Intangible Assets*.

The following table summarizes the components of gross and net intangible asset balances (in millions):

	As of 6/28/03			As of 9/28/02		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Goodwill (a)	\$ 85	\$ —	\$ 85	\$ 85	\$ —	\$ 85
Other intangible assets	5	(5)	—	5	(5)	—
Acquired technology	42	(15)	27	42	(8)	34
Total acquired intangible assets	\$ 132	\$ (20)	\$ 112	\$ 132	\$ (13)	\$ 119

(a) Accumulated amortization related to goodwill of \$55 million arising prior to the adoption of SFAS No. 142 has been reflected in the gross carrying amount of goodwill as of June 28, 2003, and September 28, 2002.

Amortization associated with acquired technology for the three and nine-month periods ended June 28, 2003 and June 29, 2002 follows (in millions):

	Three Months Ended		Nine Months Ended	
	6/28/03	6/29/02	6/28/03	6/29/02
Acquired technology amortization	\$ 2	\$ 1	\$ 7	\$ 4

Note 4 – Restructuring Actions

Fiscal 2003 Restructuring Actions

The Company recorded total restructuring charges of approximately \$27 million during the nine months ended June 28, 2003, including approximately \$7.4 million in severance costs, a \$5 million charge to write-off deferred compensation, \$7.1 million in asset impairments and a \$7.3 million charge for lease cancellations. Of the \$27 million, nearly all had been spent by the end of the third quarter of 2003, except for approximately \$500,000 of severance costs and approximately \$5.0 million related to operating lease costs on abandoned facilities. During the third quarter of 2003, approximately \$500,000 of the amount originally accrued for lease cancellations was determined to be in excess due to the sublease of a property sooner than originally estimated and an approximately \$500,000 shortfall was identified in the severance accrual due to higher than expected severance costs related to the closure of the Company's Singapore manufacturing operations. These adjustments had no net effect on reported operating expense.

Q2'03 Restructuring Actions

During the second quarter of 2003, the Company's management approved and initiated restructuring actions that resulted in recognition of a total restructuring charge of \$2.8 million, including \$2.4 million in severance costs and \$400,000 for asset write-offs and lease payments on an abandoned facility. Actions taken in the second quarter were for the most part supplemental to actions initiated in the prior two quarters and focused on further headcount reductions in various sales and marketing functions in the Company's Americas and Europe operating segments and further reductions associated with PowerSchool-related activities in the Americas operating segment, including an accrual for asset write-offs and lease payments on an abandoned facility. The second quarter actions resulted in the termination of 93 employees, 87 of who were terminated prior to the end of the third quarter of 2003.

Except for certain costs associated with operating leases on the abandoned facility, the Company currently anticipates that substantially all of the remaining accrual for severance costs of approximately \$300,000 will be spent by the end of the fourth quarter of fiscal 2003.

Q1'03 Restructuring Actions

During the first quarter of 2003, the Company's management approved and initiated restructuring actions with a total cost of \$24 million that resulted in the termination of manufacturing operations at the Company-owned facility in Singapore, further reductions in headcount resulting from the shift in PowerSchool product strategy that took place at the end of fiscal 2002, and termination of various sales and marketing activities in the United States and Europe. These restructuring actions will ultimately result in the elimination of 260 positions worldwide, all but one of which were eliminated by the third quarter of 2003.

Closure of the Company's Singapore manufacturing operations resulted in severance costs of \$1.8 million and costs of \$6.7 million to write-off manufacturing related fixed assets, whose use ceased during the first quarter. PowerSchool related costs included severance of approximately \$550,000 and recognition of \$5 million of previously deferred stock compensation that arose when PowerSchool was acquired by the Company in 2001 related to certain PowerSchool employee stockholders who were terminated in the first quarter of 2003. Termination of sales and marketing activities and employees, principally in the United States and Europe, resulted in severance costs of \$2.8 million and accrual of costs associated with operating leases on closed facilities of \$6.7 million. The total net restructuring charge of \$23 million recognized during the first quarter of 2003 also reflects the reversal of \$600,000 of unused restructuring accrual originally made during the first quarter of 2002.

Except for certain costs associated with operating leases on closed facilities, the Company currently anticipates that all of the remaining accrual for severance costs of approximately \$200,000 will be spent by the end of the fourth quarter of fiscal 2003.

The following table summarizes activity associated with restructuring actions initiated during the first and second quarters of 2003 (in millions):

	<u>Employee Severance Benefits</u>	<u>Deferred Compensation Write-off</u>	<u>Asset Impairments</u>	<u>Lease Cancellations</u>	<u>Totals</u>
Total charge	\$ 7.4	\$ 5.0	\$ 7.1	\$ 7.3	\$ 26.8
Total spending thru 6/28/03	(7.4)	—	—	(1.8)	(9.2)
Total non-cash items	—	(5.0)	(7.1)	—	(12.1)
Adjustments	0.5	—	—	(0.5)	—
Accrual at 6/28/03	<u>\$ 0.5</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 5.0</u>	<u>\$ 5.5</u>

Fiscal 2002 Restructuring Actions

During fiscal 2002, the Company recorded total restructuring charges of approximately \$30 million related to actions intended to eliminate certain activities and better align the Company's operating expenses with existing general economic conditions and to partially offset the cost of continuing investments in new product development and investments in the Company's Retail operating segment.

Q4'02 Restructuring Actions

During the fourth quarter of 2002, the Company's management approved and initiated restructuring actions with a total cost of approximately \$6 million designed to reduce headcount costs in corporate operations and sales and to adjust its PowerSchool product strategy. These restructuring actions resulted in the elimination of approximately 180 positions worldwide at a cost of \$1.8 million, 176 of which were eliminated by June 28, 2003. Eliminated positions were primarily in corporate operations, sales, and PowerSchool related research and development in the Americas operating segment. The shift in product strategy at PowerSchool included discontinuing development and marketing of PowerSchool's PSE product. This shift resulted in the impairment of previously capitalized development costs associated with the PSE product in the amount of \$4.5 million. As of June 28, 2003, substantially all of the severance accrual had been utilized, except for insignificant severance and related costs associated with 4 remaining employees identified for subsequent termination.

Q1'02 Restructuring Actions

During the first quarter of 2002, the Company's management approved and initiated restructuring actions with a total cost of approximately \$24 million. These restructuring actions resulted in the elimination of approximately 425 positions worldwide at a cost of \$8 million. Positions were eliminated primarily in the Company's operations, information systems, and administrative functions. In addition, these restructuring actions also included significant changes in the Company's information systems strategy resulting in termination of equipment leases and cancellation of existing projects and activities. The Company ceased using the assets associated with first quarter 2002 restructuring actions during that same quarter. Related lease and contract cancellation charges totaled \$12 million, and charges for asset impairments totaled \$4 million. The first quarter 2002 restructuring actions were primarily related to corporate activity not allocated to operating segments. During the first quarter of 2003, the Company reversed the remaining unused accrual of \$600,000.

The following table summarizes activity associated with restructuring actions initiated during the first and fourth quarters of 2002 (in millions):

	Employee Severance Benefits	Asset Impairments	Lease and Contract Cancellations	Totals
Q4'02 Charge	\$ 2	\$ 4	\$ —	\$ 6
Q1'02 Charge	8	4	12	24
Total spending thru 9/28/02	(10)	—	(11)	(21)
Total non-cash items	—	(8)	—	(8)
Adjustments	—	—	(1)	(1)
Accrual at 12/28/02	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$ 0</u>

Note 5 – Shareholders' Equity

CEO Restricted Stock Award

On March 19, 2003, the Company entered into an Option Cancellation and Restricted Stock Award Agreement (the Agreement) with Steven P. Jobs, its Chief Executive Officer (CEO). The Agreement cancelled stock option awards previously granted to Mr. Jobs in 2000 and 2001 for the purchase of 27.5 million common shares of the Company's common stock. Mr. Jobs retained options to purchase 60,000 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 5 million shares of the Company's common stock. The restricted stock award generally vests three years from 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.

The Company has recorded the value of the restricted stock award of \$74.75 million as a component of shareholders' equity and is amortizing that amount on a straight-line basis over the 3-year service/vesting period. The value of the restricted stock award was based on the closing market price of the Company's common stock on the date of the award. Quarterly amortization of approximately \$6.3 million is being recognized as an operating expense. The 5 million restricted shares have been included in the calculation of diluted earnings per share utilizing the treasury stock method.

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 through the end of fiscal 2000, the Company had repurchased a total of 5.05 million shares at a cost of \$191 million. No shares have been repurchased since the end of fiscal 2000. During the fourth quarter of 2001, the Company entered into a forward purchase agreement to acquire 1.5 million shares of its common stock in September of 2003 at an average price of \$16.64 per share for a total cost of \$25.5 million. The total cost to acquire the same number of shares at the closing price of the Company's common stock on June 28, 2003, would be approximately \$28.7 million. The Company was authorized to repurchase up to an additional \$283 million of its common stock as of June 28, 2003.

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 generally accepted accounting principles are recorded as an element of shareholders' equity but are excluded from net income. The Company's other comprehensive income is comprised of foreign currency translation adjustments from those subsidiaries not using the U.S. dollar as their functional currency, from unrealized gains and losses on marketable securities categorized as available-for-sale, and from 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 nine-month periods ended June 28, 2003, and June 29, 2002 (in millions):

	Three Months Ended		Nine Months Ended	
	6/28/03	6/29/02	6/28/03	6/29/02
Net income	\$ 19	\$ 32	\$ 25	\$ 110
Other comprehensive income:				
Net change in unrealized derivative gains/losses	(3)	(46)	7	(33)
Change in accumulated translation adjustment	16	11	30	7
Net change in unrealized investment gains losses	7	(7)	10	(39)
Reclassification adjustment for investment gains included in net income	(3)	—	(17)	(17)
Total comprehensive income	\$ 36	\$ (10)	\$ 55	\$ 28

The following table summarizes activity in other comprehensive income related to derivatives, net of taxes, held by the Company during the three and nine-month periods ending June 28, 2003 and June 29, 2002 (in millions):

	Three Months Ended		Nine Months Ended	
	6/28/03	6/29/02	6/28/03	6/29/02
Change in fair value of derivatives	\$ (5)	\$ (31)	\$ (9)	\$ (1)
Adjustment for net losses (gains) realized and included in net income	2	(15)	16	(32)
Change in unrealized gain on derivative instruments	\$ (3)	\$ (46)	\$ 7	\$ (33)

The following table summarizes the components of accumulated other comprehensive income, net of taxes (in millions):

	As of 6/28/03	As of 9/28/02
Unrealized gains on available-for-sale securities	\$ 6	\$ 13
Unrealized losses on derivative investments	(4)	(11)
Cumulative translation adjustments	(21)	(51)
Accumulated other comprehensive income (loss)	\$ (19)	\$ (49)

Note 6 – Employee Benefit Plans

2003 Employee Stock Option Plan

At the Annual Meeting of Shareholders held on April 24, 2003, the shareholders approved an amendment to the 1998 Executive Officer Stock Plan to change the name of the plan to the 2003 Employee Stock Option Plan (the 2003 Plan), to provide for broad-based grants to all employees in addition to executive officers and other key employees and to prohibit future “repricings” of employee stock options, including 6-months-plus-1-day option exchange programs, without shareholder approval. 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 4 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, 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. Options may be granted under the 1997 Plan to employees at not less than the fair market value on the date of grant. 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 4 years, based on continued employment, with either annual or quarterly vesting. As a result of shareholder approval of amendments to the 1998 Executive Officer Stock Plan in April 2003, the Company will terminate the 1997 Employee Stock Option Plan and cancel all remaining unissued shares, following the completion of the employee stock option exchange program in October 2003.

Employee Stock Option Exchange Program

On March 20, 2003, the Company announced a voluntary employee stock option exchange program (the Exchange Program) whereby eligible employees, other than executive officers and members of the Board of Directors, had an opportunity to exchange outstanding options with exercise prices at or above \$25.00 per share for a predetermined smaller number of new stock options issued with exercise prices equal to the fair market value of one share of the Company's common stock on the day the new awards are issued, which will be at least six months plus one day after the exchange options are cancelled. On April 17, 2003, in accordance with the Exchange Program, the Company accepted and cancelled options to purchase 16,569,193 shares of its common stock and granted a promise to issue approximately 6,892,309 new options to participating employees. The new stock options will be issued on October 20, 2003, which is the first business day that is six months and one day after cancellation of the exchanged options. No financial or accounting impact to the Company's financial position, results of operations or cash flow for the three months ended June 28, 2003, was associated with this transaction.

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 grant.

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. During the first nine months of 2003, approximately 2.1 million shares were issued under the Purchase Plan. In the third quarter of 2003, the Company's shareholders also approved an amendment to the Employee Stock Purchase Plan to increase the number of shares authorized for issuance by 4 million shares. As of June 28, 2003, approximately 4 million shares were reserved for future issuance under the Purchase Plan. Beginning with the six-month offering period that started on June 30, 2003, the number of shares authorized for issuance is limited to a total of 1 million shares per offering period.

Stock Option Activity

A summary of the Company's stock option activity and related information for the nine-month periods ended June 28, 2003, and June 29, 2002 follows (option amounts are presented in thousands):

	Shares Available For Grant	Outstanding Options	
		Number of Shares	Weighted Average Exercise Price
Balance at 9/28/02	6,571	109,430	\$ 28.17
Options Granted	(3,225)	3,225	\$ 15.12
Restricted Share Grant	(5,000)	—	—
Options Cancelled	47,689	(47,689)	\$ 39.85
Options Exercised	—	(887)	\$ 11.48
Plan Shares Expired	(1)	—	—
Balance at 6/28/03	<u>46,034</u>	<u>64,079</u>	<u>\$ 19.06</u>
Balance at 9/29/01	10,075	97,179	\$ 29.25
Additional Options Authorized	15,000	—	—
Options Granted	(22,153)	22,153	\$ 20.09
Options Cancelled	3,491	(3,491)	\$ 31.27
Options Exercised	—	(6,147)	\$ 12.06
Plan Shares Expired	(2)	—	—
Balance at 6/29/02	<u>6,411</u>	<u>109,694</u>	<u>\$ 28.29</u>

Total options outstanding at June 28, 2003 to purchase approximately 64.1 million shares do not include options to purchase approximately 6.9 million shares that are expected to be issued in October 2003 pursuant to the Employee Stock Option Exchange Program discussed above.

The options outstanding as of June 28, 2003, have been segregated into six ranges for additional disclosure as follows (option amounts are presented in thousands):

Range of Exercise Prices	Options Outstanding			Options Exercisable	
	Options Outstanding as of 6/28/03	Weighted-Average Remaining Contractual Life in Years	Weighted Average Exercise Price	Options Exercisable as of 6/28/03	Weighted Average Exercise Price
\$ 0.83 - \$ 16.81	17,266	6.33	\$ 13.39	11,087	\$ 12.17
\$ 16.82 - \$ 18.13	7,974	5.97	\$ 17.29	5,460	\$ 17.28
\$ 18.14 - \$ 18.50	17,039	7.34	\$ 18.50	10,325	\$ 18.50
\$ 18.51 - \$ 20.39	13,049	8.23	\$ 20.24	5,681	\$ 20.17
\$ 20.40 - \$ 32.28	6,012	7.74	\$ 23.49	2,646	\$ 23.51
\$ 32.29 - \$ 69.78	<u>2,739</u>	6.53	\$ 48.04	<u>1,960</u>	\$ 48.02
\$ 0.83 - \$ 69.78	<u>64,079</u>	7.08	\$ 19.06	<u>37,159</u>	\$ 18.60

Note 7 – Stock-Based Compensation

The Company has provided pro forma disclosures in Note 1 of these Notes to Condensed Consolidated Financial Statements of the effect on net income and earnings per share as if the fair value method of accounting for stock compensation had been used for its employee stock option grants and employee stock purchase plan purchases. These pro forma effects have been estimated at the date of grant and beginning of the period, respectively, using the Black-Scholes option pricing model.

For purposes of the pro forma disclosures provided pursuant to SFAS No. 123, the option awards expected to be issued in October 2003 and the awards cancelled as part of the Employee Stock Option Exchange Program have been accounted for using modification accounting. In accordance with SFAS No. 123, the grant date of the awards to be issued is the date of acceptance of the exchange offer by participating employees. The cancellation of certain of the Company's Chief Executive Officer's options and replacement with restricted shares in March 2003 is also being accounted for using modification accounting for purposes of the pro forma disclosures provided pursuant to SFAS No. 123.

The assumptions used for the three and nine-month periods ended June 28, 2003, and June 29, 2002, 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		Nine Months Ended	
	6/28/03	6/29/02	6/28/03	6/29/02
Expected life of stock options	3.5 years	4 years	3.5 - 4 years	4 years
Expected life of stock purchases	6 months	6 months	6 months	6 months
Interest rate - stock options	2.27%	4.19%	2.39%	3.96%
Interest rate - stock purchases	1.49%	2.71%	1.65%	3.57%
Volatility - stock options	40%	65%	56%	65%
Volatility - stock purchases	35%	52%	40%	51%
Dividend yields	—	—	—	—
Weighted-average fair value of options granted during the period	\$ 4.91	\$ 11.80	\$ 6.66	\$ 10.30
Weighted-average fair value of employee stock purchases during the period	\$ 3.32	\$ 6.50	\$ 4.08	\$ 6.73

Note 8 – 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 10 years and generally provide renewal options for terms of 3 to 5 additional years. Leases for retail space are for terms of 5 to 14 years and often contain multi-year renewal options. As of September 28, 2002, the Company's total future minimum lease payments under noncancelable operating leases were \$464 million, of which \$209 million related to leases for retail space. As of June 28, 2003, total future minimum lease payments related to leases for retail space increased to \$304 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 Apple software and for Apple service parts used to repair Apple hardware products. The Company provides currently for the estimated cost that may be incurred under its basic limited product warranties at the time 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 warranty claim rates, historical 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 expectations.

The following table reconciles changes in the Company's accrued warranties and related costs for the nine-month periods ended June 28, 2003 and June 29, 2002 (in millions):

	Nine Months Ended	
	6/28/03	6/29/02
Beginning accrued warranty and related costs	\$ 69	\$ 87
Cost of warranty claims	(53)	(61)
Accruals for product warranties	51	43
Ending accrued warranty and related costs	<u>\$ 67</u>	<u>\$ 69</u>

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 licensing 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 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 June 28, 2003, or September 28, 2002.

Contingencies

Beginning on September 27, 2001, three shareholder class action lawsuits were filed in the United States District Court for the Northern District of California against the Company and its Chief Executive Officer. These lawsuits are substantially identical, and purport to bring suit on behalf of persons who purchased the Company's publicly traded common stock between July 19, 2000, and September 28, 2000. The complaints allege violations of the 1934 Securities Exchange Act and seek unspecified compensatory damages and other relief. The Company believes these claims are without merit and intends to defend them vigorously. The Company filed a motion to dismiss on June 4, 2002, which was heard by the Court on September 13, 2002. On December 11, 2002, the Court granted the Company's motion to dismiss for failure to state a cause of action, with leave to plaintiffs to amend their complaint. Plaintiffs filed their amended complaint on January 31, 2003, and on March 17, 2003, the Company filed a motion to dismiss the amended complaint. A hearing on the Company's motion was held on July 11, 2003, and the Court has yet to rule on the matter.

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 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 parliament of the European Union has finalized the Waste Electrical and Electronic Equipment Directive (the Directive). The Directive makes producers of electrical goods, including personal computers, financially responsible for the collection, recycling, and safe disposal of past and future products. The Directive must now be approved and implemented by individual European Union governments by August 13, 2004, while the producers' financial obligations are scheduled to start August 13, 2005. The Company's potential liability resulting from the Directive related to past sales of its products and expenses associated with future sales of its product may be substantial. However, because it is likely that specific laws, regulations, and enforcement policies will vary significantly between individual European member states, it is not currently possible to estimate the Company's existing liability or future expenses resulting from the Directive. As the European Union and its individual member states clarify specific requirements and policies with respect to the Directive, the Company will continue to assess its potential financial impact. Similar legislation may be enacted in other geographies, including federal and state legislation in the United States, the cumulative impact of which could be significant.

Note 9 - Segment Information and Geographic Data

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 segment includes both North and South America, except for the activities of the Company's Retail segment. The Europe segment includes European countries as well as the Middle East and Africa. The Japan segment includes only Japan. The Retail segment currently operates Apple-owned retail stores in the United States. 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 Summary of Significant Accounting Policies in Note 1, 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 based on the location of the customers. Operating income for each segment includes revenue from third parties, 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 not included in standard costs, income taxes, and various nonrecurring charges. Corporate expenses include research and development, corporate marketing expenses, 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 \$30 million and \$60 million during the third quarter and first nine months of 2003, respectively. For the third quarter and first nine months of 2002, capital expenditures by the Retail segment were \$16 million and \$67 million, respectively.

Operating income for all segments, except Retail, includes cost of sales at standard cost. 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.

To assess the operating performance of the Retail segment several significant items are included in its results for internal management reporting that are not included in results of the Company's other segments. First, cost of sales for the Retail segment includes a mark-up above the Company's standard cost to approximate the price normally charged to the Company's resellers operating retail stores in the United States. For the third quarter of 2003 and the third quarter of 2002, 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 \$25 million and \$11 million, respectively. For the first nine months of 2003 and the first nine months of 2002, 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 \$71 million and \$32 million, respectively.

Second, the Retail segment includes in its net sales proceeds from sales of the Company's extended warranty and support contracts and also recognizes related cost of sales based on the amount such contracts are normally sold to the Company's resellers operating retail stores in the United States. This treatment is consistent with how the Company's major resellers account for the sales and cost of the Company's extended warranty and support contracts. 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 the Americas segment's net sales and cost of sales. For the third quarter of 2003, this resulted in the recognition of net sales and cost of sales by the Retail segment, with corresponding offsets in the Americas segment, of \$7.1 million and \$4.8 million, respectively. For the third quarter of 2002, the net sales and cost of sales recognized by the Retail segment for sales of extended warranty and support contracts were \$2.0 million and \$1.4 million, respectively. For the first nine months of 2003, this resulted in the recognition of net sales and cost of sales by the Retail segment, with corresponding offsets in the Americas segment, of \$19.3 million and \$13.2 million, respectively. This compares to similar adjustments to net sales and cost of sales during the first nine months of 2002 of \$5.0 million and \$3.5 million, respectively.

Third, a portion of the operating expenses associated with certain high profile retail stores is allocated from the Retail segment to corporate marketing expense. Allocation of these expenses reflects the unique nature of these stores which, given their larger size and extraordinary design elements, function as vehicles for general corporate marketing, corporate sales and marketing events, and brand awareness. Allocated operating costs are those in excess of operating costs incurred by one of the Company's more typical retail locations. Stores were open in three such high profile locations in New York, Los Angeles, and Chicago as of June 28, 2003. Expenses allocated to corporate marketing resulting from the operations of these stores were \$1.1 million in the third quarter of 2003 and \$3.3 million for the nine-months ended June 28, 2003. These costs were not significant during the first nine months of 2002.

Summary information by operating segment follows (in millions):

	Three Months Ended		Nine Months Ended	
	6/28/03	6/29/02	6/28/03	6/29/02
Americas:				
Net sales	\$ 831	\$ 817	\$ 2,253	\$ 2,256
Operating income	\$ 98	\$ 76	\$ 188	\$ 185
Europe:				
Net sales	\$ 297	\$ 275	\$ 986	\$ 1,003
Operating income	\$ 39	\$ 23	\$ 108	\$ 114
Japan:				
Net sales	\$ 168	\$ 168	\$ 527	\$ 578
Operating income	\$ 33	\$ 35	\$ 91	\$ 120
Retail:				
Net sales	\$ 145	\$ 63	\$ 428	\$ 181
Operating loss	\$ (2)	\$ (6)	\$ (6)	\$ (18)
Other Segments (a):				
Net sales	\$ 104	\$ 106	\$ 298	\$ 281
Operating income	\$ 13	\$ 15	\$ 40	\$ 34

- (a) Other Segments consists of Asia-Pacific and FileMaker. Certain amounts in 2002 fiscal periods related to recent acquisitions and Internet services have been reclassified from Other Segments to the Americas segment to conform to the 2003 presentation.

A reconciliation of the Company's segment operating income to the consolidated financial statements follows (in millions):

	Three Months Ended		Nine Months Ended	
	6/28/03	6/29/02	6/28/03	6/29/02
Segment operating income	181	143	421	435
Corporate expenses, net	(172)	(130)	(427)	(374)
Restructuring costs	—	—	(26)	(24)
Total operating income (loss)	<u>\$ 9</u>	<u>\$ 13</u>	<u>\$ (32)</u>	<u>\$ 37</u>

Note 10 - 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 and restricted stock is reflected in diluted earnings per share by application of the treasury stock method.

The following table sets forth the computation of basic and diluted earnings (loss) per share (in thousands, except net income and per share amounts):

	Three Months Ended		Nine Months Ended	
	6/28/03	6/29/02	6/28/03	6/29/02
Numerator (in millions):				
Income before accounting change	\$ 19	\$ 32	\$ 27	\$ 110
Cumulative effect of accounting change, net of income taxes of \$1	\$ —	\$ —	\$ (2)	\$ —
Net income	<u>\$ 19</u>	<u>\$ 32</u>	<u>\$ 25</u>	<u>\$ 110</u>
Denominator:				
Weighted average-shares outstanding	360,793	356,370	360,113	353,800
Effect of dilutive options and dilutive restricted stock	<u>2,984</u>	<u>10,512</u>	<u>2,308</u>	<u>9,638</u>
Denominator for diluted earnings per share	<u>363,777</u>	<u>366,882</u>	<u>362,421</u>	<u>363,438</u>
Basic earnings per share before accounting change				
	\$ 0.05	\$ 0.09	\$ 0.07	\$ 0.31
Cumulative effect of accounting change, net of tax	—	—	—	—
Basic earnings per share after accounting change	<u>\$ 0.05</u>	<u>\$ 0.09</u>	<u>\$ 0.07</u>	<u>\$ 0.31</u>
Diluted earnings per share before accounting change				
	\$ 0.05	\$ 0.09	\$ 0.07	\$ 0.30
Cumulative effect of accounting change, net of tax	—	—	—	—
Diluted earnings per share after accounting change	<u>\$ 0.05</u>	<u>\$ 0.09</u>	<u>\$ 0.07</u>	<u>\$ 0.30</u>

Options to purchase approximately 51 million and 45 million shares of common stock that were outstanding at June 28, 2003 and June 29, 2002, respectively, were not included in the computation of diluted earnings per share for the quarters then ended because the options' exercise prices were greater than the average market price of the Company's common stock during those quarters, and therefore, their effect would have been antidilutive.

Note 11 – Related Party Transactions and Certain Other Transactions

In March 2002, the Company entered into a Reimbursement Agreement with its Chief Executive Officer, 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 is effective for expenses incurred by Mr. Jobs for Apple business purposes since he took delivery of the plane in May 2001. The Company recognized a total of \$105,000 in expenses pursuant to the Reimbursement Agreement during the third quarter of 2003, and \$266,000 in expenses for the nine-months ended June 28, 2003. For fiscal 2002, the Company recognized a total of \$1,168,000 in expenses pursuant to the Reimbursement Agreement related to expenses incurred by Mr. Jobs during 2001 and 2002. All expenses recognized pursuant to the Reimbursement Agreement have been included by the Company in selling, general, and administrative expenses.

Mr. Jerome York, a member of the Board of Directors of the Company, is a member of an investment group that purchased MicroWarehouse, Inc. (“*MicroWarehouse*”) in January 2000. He also serves as its Chairman, President and Chief Executive Officer. MicroWarehouse is a multi-billion dollar specialty catalogue and online retailer and direct marketer of computer products, including products made by the Company, through its MacWarehouse catalogue. MicroWarehouse accounted for 2.3% and 2.9% of the Company’s net sales for the three and nine-month periods ended June 28, 2003, respectively, and 3.3% of the Company’s net sales in fiscal 2002. Trade receivables from MicroWarehouse were \$12.7 million and \$20.9 million as of June 28, 2003, and September 28, 2002, respectively. Sales to MicroWarehouse and related trade receivables are generally subject to the same terms and conditions as those with the Company’s other resellers. In addition, the Company purchases miscellaneous equipment and supplies from MicroWarehouse. Total purchases amounted to approximately \$431,000 and \$1.7 million for the three and nine-month periods ended June 28, 2003, respectively, and \$2.9 million in fiscal 2002.

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, including statements regarding the expected timing and features of new product introductions, statements under the heading "Business Outlook," statements regarding gross margin and provision for income tax in future periods, statements regarding income tax provisions, statements regarding the likely impact on the Company of new accounting standards, statements about the sufficiency of current cash balances, statements regarding the impact on the Company or outcome of litigation, statements about capital expenditures in future periods and statements regarding the impact on the Company of restructuring actions. 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 2002 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.

Available Information

Beginning in fiscal 2003, 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 our website at www.apple.com/investor when such reports are available on the Securities and Exchange Commission website. The contents of this website are not incorporated into this filing. Further, our reference to the URL for this website is intended to be an inactive textual reference only.

Critical Accounting Policies

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 requires the Company's management to make judgments, assumptions, and estimates that affect the amounts reported in its consolidated financial statements and accompanying notes. Note 1 of the Notes to Consolidated Financial Statements in the Company's 2002 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 that 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.

Management believes the Company's critical accounting policies are those related to revenue recognition, allowance for doubtful accounts, inventory valuation and exposures related to inventory purchase commitments, valuation of long-lived assets including acquired intangibles, and valuation of non-current debt and equity investments. 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. Additional information about these critical accounting policies may be found in the Company's 2002 Form 10-K in Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations," under the heading "Critical Accounting Policies."

Accounting for Stock-Based Compensation

The Company currently measures compensation expense for its employee stock-based compensation plans using the intrinsic value method prescribed by Accounting Principles Board (APB) Opinion 25, *Accounting for Stock Issued to Employees* and provides pro forma disclosures of the effect on net income and earnings per share as if the fair value-based method had been applied in measuring compensation expense. The Company has elected to follow APB No. 25 because, as discussed in Note 1 of the Notes to Condensed Consolidated Financial Statements provided in this Form 10-Q, the alternative fair value accounting provided for under SFAS No. 123, *Accounting for Stock-Based Compensation*, requires use of option valuation models that were not developed for use in valuing employee stock options and employee stock purchase plan shares. Under APB Opinion No. 25, when the exercise price of the Company's employee stock options equals the market price of the underlying stock on the date of the grant, no compensation expense is recognized.

The Financial Accounting Standards Board (FASB) decided on April 22, 2003 to require all companies to expense the value of employee stock options. Companies will be required to measure the cost of employee stock options

according to their fair value. The FASB has indicated that it plans to issue in the near future an exposure draft of a new accounting standard addressing this matter. This new accounting standard could become effective as early as 2004. Prior to issuance of this exposure draft, the FASB has indicated it will be addressing several significant technical issues. Among other things, the FASB must determine the extent to which the new accounting standard will permit adjustments to recognized expense for actual option forfeitures and actual performance outcomes. This determination will affect the timing and amount of compensation expense recognized. Also, a method to determine the fair value of employee stock options must be established. Current accounting standards require use of an option-pricing model, such as the Black-Scholes model, to determine fair value and provide guidance on adjusting some of the input factors used in the model. This valuation approach has received significant criticism and may be subject to changes that could have a significant impact on the calculated fair value of employee stock options under the new standard.

At the Company's annual shareholder's meeting on April 24, 2003, shareholders approved a proposal requesting that the Company's Board of Directors (the Board) establish a policy of expensing the value of all future employee stock options issued by the Company. The Board and management appreciate and take seriously the views expressed by the Company's shareholders. As discussed in the Company's Form 10-Q for the period ended March 29, 2003, the Company had decided not to expense the value of employee stock options until the FASB finalizes its new accounting standard on the matter. The Company based this decision on the FASB's announced intention to soon require all companies to expense the value of employee stock options and the FASB's near-term review of technical issues that will play a significant role in determining the fair value of and accounting for employee stock options. The Company monitors progress at the FASB and other developments with respect to the general issue of employee stock compensation. Further, the Company is evaluating its current employee compensation programs. In the future, should the Company expense the value of employee stock options, either out of choice or due to new requirements issued by the FASB, and/or decide to alter its current employee compensation programs to provide other benefits in place of options, including restricted stock grants or additional cash bonuses, the Company may have to recognize substantially more compensation expense in future periods that could have a material adverse impact on the Company's future results of operations.

Internet Services Update

In April 2003, the Company launched the iTunes® Music Store in the United States, an online music store that allows customers to find, purchase, and download music for 99 cents per song or, in most cases, \$9.99 per album. Requiring no subscription fee, the iTunes Music Store offers customers a broad range of personal rights to the songs they purchase including playing songs on up to three Macintosh® computers, burning songs onto an unlimited number of CDs for personal use, playing songs on an unlimited number of iPod™ portable digital music players, and using songs in any application on their Macintosh system including iPhoto™, iMovie®, and iDVD™. The Company currently expects to deliver a Windows version of the iTunes Music Store before the end of calendar 2003.

Users can easily search the contents of the entire music store to locate songs by title, artist, or album, or browse the entire contents of the music store by genre and artist. Users can also listen to a free 30-second preview of any song in the store. The iTunes Music Store is fully integrated into the latest version of iTunes, allowing customers to purchase, download, organize, share, and listen to their digital music using a single application.

Hardware Products Update

Power Mac® G5

In June 2003, the Company announced the Power Mac G5 that is expected to be available in August 2003. Powered by the PowerPC G5 processor designed by IBM and Apple and featuring up to a 1 GHz front-side bus and the ability to address up to 8GB of memory, the Power Mac G5 utilizes 64-bit processing technology for advanced 64-bit computation, while running existing 32-bit applications natively. The PowerPC G5 processor architecture is based on a completely new execution core that features massively parallel computation, full symmetric multi-processing, two double precision floating point units and an optimized Velocity Engine™.

Power Mac G5 systems include Gigabit Ethernet, FireWire® 800, two FireWire 400 ports, three USB 2.0 ports, dual display support, optical digital audio input and output, analog audio input and output, and a headphone jack. The system also supports 54 Mbps AirPort® Extreme wireless networking and is Bluetooth ready for wireless connections to a host of Bluetooth-enabled peripherals.

The Power Mac G5 features a new anodized aluminum alloy enclosure designed to meet the needs of professional users. The new enclosure is built around four independently controlled thermal zones for advanced airflow management, with fans in each zone that are individually controlled based on a sophisticated combination of thermal and power monitoring, resulting in the Power Mac G5 running substantially quieter than the previous Power Mac G4. The G5 enclosure also features an easy-to-open access panel allowing quick access to internal components for tool-less installation of memory, hard drives, optical drives or an AirPort Extreme card. Front and rear handles allow professionals to rapidly and safely move Power Mac G5s when and where they need them, and front-mounted FireWire, USB 2.0, and headphone ports provide convenient access for popular peripherals.

iPod™

The Company introduced new iPod models in April 2003. The new iPod is smaller and lighter than previous versions and is available in three models with storage capacity of either 10GB, 15GB, or 30GB; the latter holding up to 7,500 songs. In addition to MP3, iPod now supports the AAC audio format. The new iPod also features solid-state interfaces and is available with a new dock that facilitates fast and easy connection to a computer or stereo.

Xserve® and Xserve RAID Storage System

In February 2003, the Company upgraded its Xserve 1U rack servers with more powerful processors, more storage capacity, and a FireWire® 800 interface. At the same time, the Company introduced the Xserve RAID Storage System, a rack storage system that holds up to 14 hot-swappable drive modules capable of holding up to 2.5 terabytes of data. Xserve RAID architecture combines affordable, high-capacity ATA/100 drive technology with a Fibre channel interface for reliable and fast data access. Xserve RAID provides RAID level 5 throughput that supports affordable real-time HD 1080i video editing.

PowerBook®

In January 2003, the Company introduced two new PowerBook models. The 17-inch PowerBook G4 features a 17-inch wide-format active-matrix display, is encased in a durable aluminum alloy enclosure, is 1-inch thick, and weighs as little as 6.8 pounds. The new 17-inch PowerBook G4 also features built-in support for AirPort® Extreme 54 Mbps 802.11g wireless networking, new high-speed FireWire 800, a backlit keyboard with ambient light sensors, and built-in Bluetooth for wireless connection to cell phones and other Bluetooth equipped peripherals. The 12-inch PowerBook G4 features a 12-inch, active-matrix display housed in a lightweight, durable aluminum alloy enclosure weighing approximately 4.6 pounds. The 12-inch PowerBook G4 features a high-speed PowerPC G4 processor, NVIDIA graphics, built-in Bluetooth wireless networking, and battery life of up to five hours on a single charge.

Peripheral Products Update

iSight™

The Company introduced the iSight digital video camera and the beta version of its iChat™ AV software application in June 2003. Together they enable high-quality audio and video conferences between two Macintosh systems over broadband connections. iSight is a small, portable aluminum alloy camera with all audio, video and power provided by a single FireWire cable. iSight features a custom designed lens with auto-focus and a high-end CCD sensor to provide high-resolution images and full-motion video at up to 30 frames per second. iSight includes an integrated microphone that suppresses ambient noise for clear digital audio. With its on-board processor, iSight automatically adjusts color, white balance, sharpness and contrast to provide high-quality images with accurate color reproduction in any lighting conditions. iSight is designed to be center-mounted on the top of any computer screen and uses its integrated tilt and rotate mechanism to easily position the camera for natural, face-to-face video conferencing.

AirPort® Extreme™

AirPort Extreme is the Company's next generation of Wi-Fi wireless networking technology based on the new ultra-fast 802.11g standard. With speeds up to 54 Mbps, AirPort Extreme delivers almost five times the data rate of today's 802.11b based products, yet is fully compatible with the millions of 802.11b Wi-Fi devices around the world. AirPort Extreme Base Stations can serve up to 50 Macintosh and Windows users simultaneously, provide wireless bridging to extend the range beyond just one base station, and support USB printer sharing to allow multiple users to wirelessly share USB printers connected directly to the base station. AirPort Extreme was introduced in January 2003.

Displays

In January 2003, the Company introduced the 20-inch Apple Cinema Display® and instituted significant price reductions on its 23-inch Cinema HD Display and its 17-inch Apple Studio Display®. The new 20-inch Apple Cinema Display features an active-matrix, liquid crystal display that incorporates a digital interface.

Software Products and Computer Technologies Update

Mac OS® X Panther

In June 2003, the Company announced Mac OS X version 10.3 “Panther,” the next major version of Mac OS X that is expected to ship by the end of calendar 2003. The fourth major release of Mac OS X in four years, Panther will incorporate many new features including a completely new Finder™; Exposé, a new way to organize windows and instantly see all open windows at once; FileVault, a new feature that secures the contents of a home directory with 128-bit AES encryption; and enhanced support for use on Windows-based networks.

Additional new features in Panther include:

- an enhanced Mail application that organizes email into convenient threads with drag-and-drop addressing and a Safari™-based engine for displaying HTML formatted email;
- Fast User Switching, allowing users to share a single Mac and quickly switch between accounts without having to quit running applications and completely logout of the system;
- a fully integrated iDisk that increases productivity by automatically syncing a user’s offline work to their .Mac Internet server storage once they are online again, so users can work locally on files and have them synced automatically back to their iDisk later;
- integrated faxing synced with the Address Book so sending and receiving faxes is as easy as printing, and includes support for adding cover pages;
- Font Book, a new application that provides system-level font management with double-click font preview, one-click installation and an intuitive iTunes®-like interface for managing font collections, and searching, activating and deactivating fonts;
- a significantly improved Preview application that is a fast PDF reader with fast text searching that builds an instant index of search results in a PDF, text selection and copying, URL support and support for the PDF 1.4 format. Preview leverages powerful improvements to Quartz filtering technology such as colorspace conversion, image sampling and compression for advanced PDF workflows; and
- iChat™ AV, a desktop video conferencing solution for business, education and consumers.

Mac OS® X Panther Server

In June 2003, the Company previewed Mac® OS X version 10.3 “Panther” Server, the next major release of the Company’s UNIX-based server operating system that makes it easy to deploy popular open source solutions for Macintosh, Windows and Linux clients. Panther Server includes powerful open source solutions and easy to use server management capabilities. New features in Panther Server include Automatic Setup for easily setting up multiple servers; Open Directory 2 for hosting scalable LDAP directory and Kerberos authentication services; Samba 3 for providing login and home directory support for Windows clients; and the JBoss application server for running powerful J2EE applications.

iChat™ AV

The Company introduced the beta version of its iChat™ AV software application and the iSight™ digital video camera in June 2003. Together they enable high-quality audio and video conferences between two Macintosh systems over broadband connections. iChat AV also features audio conferences over dial-up connections to the Internet. iChat AV requires no set up or configuration beyond installing the software and plugging in a FireWire® video camera and microphone.

Soundtrack

The Company announced Soundtrack in July 2003. Soundtrack, which is expected to be available in August 2003, is a royalty-free music production tool previously available only with Final Cut Pro® 4. Soundtrack includes more than 4,000 royalty-free, professionally-recorded audio loops and sound effects, giving creative professionals such as video editors, DVD authors and web developers a powerful and easy-to-use tool to create high-quality music scores. Soundtrack also ships with over 30 professional, high-quality audio plug-ins. Plug-ins like Platinum Verb, SpectralGate, Multiband Compressor and AutoFilter, enable users to combine effects with individual tracks to create sophisticated audio. Furthermore, Soundtrack's support for Mac® OS X's Audio Units plug-in architecture allows users to further expand their capabilities with additional third-party audio effects developed through the Company's open-standard plug-in format.

Final Cut Pro® 4

Final Cut Pro 4, a major upgrade to the Company's professional editing software for film and video, was announced in April 2003 and released in June 2003. Final Cut Pro 4 software introduces RT Extreme for real-time compositing and effects, new interface customization tools, new high-quality 8- and 10-bit uncompressed formats, and full 32-bit floating point per channel video processing. Final Cut Pro 4 also includes three completely new integrated applications – Live Type for advanced titling, Soundtrack for music creation, and Compressor for full featured batch transcoding.

Safari™ 1.0

In June 2003, the Company introduced Safari™ 1.0, the Company's new Mac OS® X compatible web browser that is capable of loading web pages rapidly. Safari uses the advanced interface technologies underlying Mac OS X and includes built-in Google search; SnapBack to instantly return to search results; a new way to name, organize and present bookmarks; tabbed browsing; and automatic "pop-up" ad blocking. The Company also released a software development kit that allows developers to embed the Safari HTML rendering engine directly into their applications.

DVD Studio Pro® 2

The Company announced DVD Studio Pro 2 in April 2003. It is a completely new DVD authoring product, rebuilt from the ground up with a new user interface, professionally designed and fully customizable templates, an innovative new menu editor, timeline-based track editing and a new software-based MPEG-2 encoder.

Shake® 3

Shake 3, an upgrade of the Company's compositing and visual effects software, was announced in April 2003 and released in June 2003. Shake 3 includes new Mac® OS X only features such as the Shake Qmaster network render management software and unlimited network rendering licenses which allow visual effects artists to easily distribute rendering tasks across a cluster of Apple's Xserve rack servers or desktop Power Mac G4 computers for enhanced performance and efficiency. Shake 3 also includes new visual effects features available to Mac OS X, Linux and IRIX customers including motion-tracking and real-time broadcast preview.

Final Cut® Express

Final Cut Express, introduced in January 2003, is a new product based on Apple's award-winning Final Cut Pro software. Final Cut Express enables small business users, educators, students and advanced hobbyists to perform professional-quality digital video editing. Final Cut Express includes key features used by video editors such as the same interface and workflow as Final Cut Pro, powerful video editing tools, hundreds of special effects, and easy delivery of output to DVD, the Internet, or tape.

Keynote™

Keynote is the Company's new presentation software introduced in January 2003 that gives users the ability to create high-quality presentations. Designed to be easy to use, Keynote includes professionally designed themes, advanced typography, professional-quality image resizing, animated charts and tables that can be created quickly, and cinematic-quality transitions. Keynote imports and exports PowerPoint, QuickTime®, and PDF files to simplify the creation and sharing of presentations.

iLife™

Introduced in January 2003, iLife is the Company's integrated suite of four digital lifestyle applications that features the Company's iTunes®, iPhoto™, iMovie™, and iDVD™ software applications. These applications are integrated to allow users to easily access their digital music, photos and movies from within each application.

Business Outlook

For the fourth quarter of 2003, the Company expects a high single-digit percentage increase in net sales from the third quarter and a slight sequential increase in quarterly earnings. The Company expects fourth quarter gross margin to be approximately 100 basis points lower than the third quarter due to lower Mac OS sales and increased manufacturing costs associated with the production ramp-up of new Power Mac G5 systems. Fourth quarter reported operating expenses are expected to be approximately \$420 million. This excludes approximately \$10 million of software development costs related to development of Mac OS X Panther that the Company anticipates capitalizing during the fourth quarter. The Company expects fourth quarter interest and other income, net to decline to approximately \$10 million due to lower interest yields on the Company's investment portfolio. The Company's expects its effective tax rate to remain at 28% during the fourth quarter.

The foregoing statements concerning the Company's fourth quarter 2003 anticipated net sales, gross margin, operating expenses, interest and other income, net, effective tax rate, earnings, capitalized software development costs, Mac OS sales, and production ramp expenses are forward-looking. The Company's actual results could differ. The Company's future operating results and financial condition are dependent upon general economic conditions, market conditions within the PC industry, and the Company's ability to successfully develop, manufacture, and market technologically innovative products in order to meet the dynamic conditions within the highly competitive market for personal computers. Some of the potential risks and uncertainties that could affect the Company's future operating results and financial condition are discussed throughout this Item 2, including the discussion under the heading below "Factors That May Affect Future Results and Financial Condition," and in the 2002 Form 10-K.

Net Sales

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			Nine Months Ended		
	6/28/03	6/29/02	Change	6/28/03	6/29/02	Change
Net Sales by Operating Segment:						
Americas net sales (a)	\$ 831	\$ 817	2%	\$ 2,253	\$ 2,256	0%
Europe net sales	297	275	8%	986	1,003	(2)%
Japan net sales	168	168	0%	527	578	(9)%
Retail net sales	145	63	130%	428	181	136%
Other segments net sales (a)	104	106	(2)%	298	281	6%
Total net sales	<u>\$ 1,545</u>	<u>\$ 1,429</u>	8%	<u>\$ 4,492</u>	<u>\$ 4,299</u>	4%
Unit Sales by Operating Segment:						
Americas Macintosh unit sales	452	478	(5)%	1,167	1,261	(7)%
Europe Macintosh unit sales	144	160	(10)%	526	586	(10)%
Japan Macintosh unit sales	85	98	(13)%	263	326	(19)%
Retail Macintosh unit sales	40	20	100%	128	58	121%
Other segments Macintosh unit sales (a)	50	52	(4)%	141	136	4%
Total Macintosh unit sales	<u>771</u>	<u>808</u>	(5)%	<u>2,225</u>	<u>2,367</u>	(6)%
Net Sales by Product:						
Power Macintosh net sales (b)	\$ 234	\$ 285	(18)%	\$ 819	\$ 1,034	(21)%
PowerBook net sales	363	234	55%	951	689	38%
iMac net sales	301	424	(29)%	959	1,076	(11)%
iBook net sales	196	217	(10)%	563	641	(12)%
Total Macintosh net sales	1,094	1,160	(6)%	3,292	3,440	(4)%
Peripherals and other hardware (c)	285	148	93%	719	481	49%
Software (d)	90	64	41%	273	200	37%
Service and other sales	76	57	33%	208	178	17%
Total other net sales	<u>451</u>	<u>269</u>	68%	<u>1,200</u>	<u>859</u>	40%
Total net sales	<u>\$ 1,545</u>	<u>\$ 1,429</u>	8%	<u>\$ 4,492</u>	<u>\$ 4,299</u>	4%
Unit Sales by Product:						
Power Macintosh unit sales	133	167	(20)%	447	590	(24)%
PowerBook unit sales	161	94	71%	428	299	43%
iMac unit sales	287	378	(24)%	841	983	(14)%
iBook unit sales	190	169	12%	509	495	3%
Total Macintosh unit sales	<u>771</u>	<u>808</u>	(5)%	<u>2,225</u>	<u>2,367</u>	(6)%
Net sales per Macintosh unit sold (e)	<u>\$ 1,419</u>	<u>\$ 1,436</u>	(1)%	<u>\$ 1,480</u>	<u>\$ 1,453</u>	2%
iPod unit sales	304	54	463%	603	241	150%
iPod net sales	<u>\$ 111</u>	<u>\$ 22</u>	405%	<u>\$ 224</u>	<u>\$ 90</u>	149%

Notes:

- Other Segments consists of Asia Pacific and FileMaker. Certain net sales in 2002 fiscal periods related to recent acquisitions and Internet services have been reclassified from Other Segments net sales to Americas segment net sales to conform to the 2003 presentation.
- Power Macintosh figures include server sales.
- Net sales of peripherals and other hardware include sales of iPod, Apple-branded and third-party displays, and other hardware accessories.
- Net sales of software include sales of Apple-branded operating system and application software and sales of third-party software.
- Net sales per Macintosh unit sold are derived by dividing total Macintosh net sales by total Macintosh unit sales.

Net sales during the third quarter of 2003 increased 8% or \$116 million from the same period in 2002, and increased 4% or \$193 million for the first nine months of fiscal 2003 compared to the same period in 2002. Several factors have contributed favorably to net sales during both the third quarter and the first nine months of 2003 including:

- Net sales of peripherals and other hardware rose \$137 million or 93% during the third quarter of 2003 compared to the same quarter in 2002 and rose \$238 million or 49% for the first nine months of 2003. These increases are the result of significant year-over-year increases in quarterly and year-to-date iPod net sales experienced in all of the Company's operating segments. iPod sales during the third quarter of 2003 were favorably affected by introduction of substantially redesigned new models during the quarter and by the Company's introduction of its iTunes Music Store. Net sales of peripherals and other hardware during 2003 also reflect an overall increase in net sales of other computer accessories, the majority of which was experienced by the Company's Americas, Europe, and Retail segments.
- Net sales of software rose \$26 million or 41% during the third quarter of 2003 compared to the same quarter in 2002 and rose \$73 million or 37% for the first nine months of 2003. These increases reflect higher net sales of Apple-branded application software, Mac OS X client and server software, and third-party software. Net sales of Apple-branded software during the first nine months of 2003 was favorably affected by several new software titles including Final Cut Express, iLife, Keynote, and titles acquired by the Company from Emagic during the fourth quarter of 2002. Growth in net sales of third-party software was particularly strong in the Retail segment for the third quarter and first nine months of 2003.
- Service and other net sales rose \$19 million or 33% during the third quarter of 2003 compared to the same quarter in 2002 and rose \$30 million or 17% for the first nine months of 2003. These increases are the result of significant year-over-year increases in quarterly and year-to-date net sales associated with AppleCare and related services and increases in net sales associated with Internet services. Increased net sales associated with AppleCare are primarily the result of higher attach rates on AppleCare protection plans over the last several years. Increased net sales associated with Internet services are due primarily to introduction of the iTunes Music Store during the third quarter of 2003 and increased net sales from the Company's .Mac Internet service.
- The Retail segment's net sales grew to \$428 million during the first nine months of 2003 from \$181 million during the same period in 2002, a 136% increase. The Retail segment's 2003 third quarter net sales rose \$82 million or 130% from the third quarter of 2002. While the Company's customers in areas where the Retail segment has opened stores may elect to purchase from the Retail segment stores rather than the Company's preexisting sales channels in the United States, the Company believes that a substantial portion of the Retail segment's net sales is incremental to the Company's total net sales. See additional comments below related to the Retail segment under the heading "Segment Operating Performance."
- Although total Macintosh unit sales were down 6% during the first nine months of 2003 compared to the same period in 2002, unit sales of portable systems have been relatively strong. PowerBook unit sales were up 71% and 43% during the first three and nine months of 2003 versus the same periods in 2002, respectively. iBook unit sales were up 12% and 3% during the first three and nine months of 2003 versus the same periods in 2002, respectively. Increased sales of portable systems reflect an overall trend in the industry towards portable systems. Portable systems represented a record high 46% of all Macintosh systems sold during the third quarter of 2003. Additionally, new PowerBook models introduced during the first six months of 2003, including two new form factors featuring 12-inch and 17-inch displays and the Company's first portable product capable of burning DVDs, have been well received by customers.

Offsetting the favorable factors discussed above, the Company's net sales during the third quarter and first nine months of 2003 were negatively impacted by three notable factors.

- Total unit sales of desktop systems fell 23% and 18% during the third quarter and first nine months of 2003 compared to the same periods in 2002. Unit sales of iMac systems were down 24% during the third quarter of 2003 versus the same quarter in 2002 and were down 15% for the first 9 months of 2003 compared to the same period in 2002. iMac sales have been negatively affected by the shift in sales away from desktop systems in favor of portables. Also, the current flat panel iMac form factor is in the seventh quarter of its life cycle.

- Unit sales of Power Macintosh systems fell 20% during the third quarter of 2003 and 24% during the first nine months of 2003 compared to the same periods in 2002. These declines in unit sales of Power Macintosh systems are consistent with the declining sales of Power Macintosh systems experienced by the Company during recent years. In part, declines in Power Mac sales reflect the shift in sales to portable models, particularly PowerBooks. Also, the Company continues to believe that weak economic conditions over the past several years are having a pronounced negative impact on its professional and creative customers and that many of these customers continue to delay upgrades of their Power Macintosh systems due to the Company's ongoing transition to Mac OS X, customer perception of microprocessor clock speed on overall system performance, and in anticipation of the introduction of Power Mac G5 systems that were announced in June 2003 and are currently expected to begin shipping to customers during the fourth quarter of 2003. Additionally, some of the Company's professional and creative customers may be delaying upgrades of their systems in anticipation of certain software vendors transitioning their professionally oriented Macintosh software applications, such as QuarkXPress, to run natively in Mac OS X. However, the Company did not experience the anticipated increase in Power Macintosh sales that it expected following the introduction of Adobe's PhotoShop 7 for Mac OS X during 2002.
- The Company has experienced ongoing weakness in its U.S. education channel during the first nine months of 2003. Net sales in U.S. education during the first nine months of 2003 were down approximately 3% from the same period in 2002. Further, although the Company was encouraged that unit sales in U.S. education grew 5% during the third quarter of 2003 compared to the same quarter in 2002, net sales for the quarter were slightly down on a year-over-year basis. Despite the year-over-year increase in unit sales for the third quarter of 2003 in the U.S. education channel, net sales declined primarily as a result of a shift in mix away from higher priced Power Mac and iMac systems towards lower priced eMac and iBook systems. The Company believes weakness in its U.S. education channel has been caused by multiple factors including funding pressures due to weak economic conditions, large budget deficits in many states, and due to increased competition. Although the Company did experience growth in quarterly unit sales during the third quarter of 2003 and has taken steps, and will continue to take steps, to address weakness in the U.S. education channel, it remains difficult to anticipate when and if this negative trend will reverse.
- The personal computer industry in general, and the Company specifically, continue to see relatively soft demand for their products. Sales of professional and consumer oriented Macintosh systems remain far below levels experienced in fiscal 2000 and earlier. Worsening global economic conditions over the past three years exacerbated by the economic and political uncertainties caused by terrorist activities and the associated international responses have clearly had a pronounced negative effect on the overall demand for the Company's products in virtually all of its markets. Further, growth in the overall personal computer industry has slowed due to the high market penetration of personal computers and a lengthening of consumer, creative, and business personal computer upgrade cycles. In summary, the Company believes that expansion in the overall market for personal computers has slowed and that significant growth continues to await a combination of economic recovery and meaningful technological advancements.

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 segment includes both North and South America, except for the activities of the Company's Retail segment. The Europe segment includes European countries as well as the Middle East and Africa. The Japan segment includes only Japan. The Retail segment currently operates Apple-owned retail stores in the United States. 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 Item 1 of this Form 10-Q in the Notes to Condensed Consolidated Financial Statements at Note 9, "Segment Information and Geographic Data."

Americas

Net sales in the Americas segment during the third quarter of 2003 increased \$14 million or 2% compared to the same quarter in 2002, and declined \$3 million for the first nine months of 2003 compared to the same period in 2002. Both the quarterly and year-to-date results of the America's segment are similar to the overall results of the Company as they reflect substantially lower unit sales and net sales of Power Macintosh systems and iMac systems partially offset by significant increases in unit sales and net sales of PowerBooks. The net sales of the Americas

segment, and the Company in total, also reflect substantially higher sales of peripherals, software, and services during the third quarter and first nine months of 2003 versus the same periods in 2002. The Americas segment has been negatively affected by weakness in its U.S. education channel. As noted above, the Company was encouraged that unit sales in U.S. education grew 5% during the third quarter of 2003 compared to the same quarter in 2002. However, total net sales and unit sales in the U.S. education channel during the first nine months of 2003 were down 3% and 2%, respectively, compared to the same period in 2002. The Company believes the cause for this decline is that U.S. educational institutions appear to have reduced or postponed capital spending due to federal and state funding concerns and tax revenue shortfalls resulting from the weak economy and that competition in this market is increasing. Additionally, some of the decline during 2003 in net sales and unit sales of Macintosh systems in the Americas segment may be the result of the operation of the Company's Retail segment whose net sales, all of which occur within the U.S., increased significantly during the nine months of 2003.

Europe

Net sales in Europe increased \$22 million or 8% during the third quarter of 2003 as compared to the same quarter in 2002, and decreased \$17 million or 2% during the first nine months of 2003 as compared to the same period in 2002. Total Macintosh unit sales in Europe for the three and nine-month periods ended June 28, 2003, were both down 10%. Europe has experienced weakened demand for Power Macintosh and iMac systems in 2003 and strong demand for PowerBooks, peripherals, and software. Demand for PowerBooks was particularly strong in Europe during the third quarter of 2003.

Japan

Net sales in the Japan segment during the third quarter of 2003 were flat at \$168 million as compared to the same quarter in 2002. However, net sales in Japan decreased \$51 million or 9% during the first nine months of 2003 as compared to the same period in 2002, the weakest year-to-date performance in 2003 of any of the Company's operating segments. Japan's Macintosh unit sales have been particularly weak in 2003, declining 13% and 19% during the third quarter and first nine months of 2003, respectively, compared to the same periods in 2002. Japan's Macintosh unit sales remain significantly below the segment's historic levels due to current economic conditions that remain particularly negative in Japan. Further, while Japan has experienced substantial increases in net sales of both other hardware and software, these increases were somewhat less than those experienced by the Company's other operating segments.

Retail

The Company opened three new retail stores during the third quarter of 2003, bringing the total number of open stores to 59 as of the end of the third quarter of 2003. This compares to 31 stores as of the end of the third quarter of 2002. The Retail segment's net sales grew to \$428 million during the first nine months of 2003 from \$181 million during the same period in 2002, a 136% increase. Third quarter net sales in 2003 grew 130% from the same quarter in 2002 and rose \$10 million or 7% from the second quarter of 2003. The Retail segment has contributed strongly to the increases in net sales of computer peripherals and software experienced by the Company during 2003. During the first nine months of 2003, approximately 44% of the Retail segment's net sales came from the sale of Apple-branded and third-party peripherals and software. This compares to 27% for the Company as a whole.

As measured by the Company's operating segment reporting, the Retail segment lost \$6 million during the first nine months of 2003 compared to \$18 million during the same period in 2002. This improvement is primarily attributable the segment's year-over-year increase in net sales.

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 \$198 million through the end of fiscal 2002, and totaled \$60 million during the first nine months of 2003. As of June 28, 2003, the Retail segment had approximately 1,200 employees and had outstanding operating lease commitments associated with retail store space and related facilities of \$304 million. The Company would incur substantial costs should it choose to terminate its Retail segment or close individual stores. Such costs could adversely affect the Company's results of operations and financial condition. Investment in a new business model such as the Retail segment is inherently risky, particularly in light of the significant investment involved, the current economic climate, and the fixed nature of a substantial portion of the Retail segment's operating expenses. Results for this segment are dependent upon a number of risks and uncertainties, some of which are discussed below under the heading "Factors That May Affect Future Results and Financial Condition."

Gross Margin

Gross margin for the three and nine months ended June 28, 2003 and June 29, 2002 were as follows (in millions, except gross margin percentages):

	Three Months Ended		Nine Months Ended	
	6/28/03	6/29/02	6/28/03	6/29/02
Net sales	\$ 1,545	\$ 1,429	\$ 4,492	\$ 4,299
Cost of sales	1,117	1,038	3,240	3,077
Gross margin	\$ 428	\$ 391	\$ 1,252	\$ 1,222
Gross margin percentage	27.7%	27.4%	27.9%	28.4%

Gross margin for the first nine months of 2003 was 27.9% compared to 28.4% for the same period in 2002. The year-over-year decline in gross margin during the first nine months of 2003 reflects relatively aggressive pricing beginning in late fiscal 2002 on several Macintosh models and lower sales of relatively higher margin Power Macintosh systems partially offset by a higher mix of higher margin portable products, peripherals, and software.

As noted above, the Company expects fourth quarter gross margin to be approximately 100 basis points lower than the third quarter due to lower sales of the Macintosh operating system and increased manufacturing costs associated with the production ramp-up of new Power Mac G5 systems. However, the Company's gross margin and the gross margin of the personal computer industry are expected to remain under pressure during upcoming quarters in light of weak economic conditions, flat demand for personal computers in general, price competition in the PC industry, and potential increases in component pricing.

The foregoing statements regarding the Company's expected gross margin during the fourth quarter of 2003, general demand for personal computers, anticipated industry component pricing, and future economic conditions 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. In general, gross margins and margins on individual products will remain under significant downward pressure due to a variety of factors, including continued industry wide global pricing pressures, increased competition, compressed product life cycles, potential increases in the cost and availability of raw material and outside manufacturing services, and potential changes to the Company's product mix, including higher unit sales of consumer products with lower average selling prices and lower gross margins. In response to these downward pressures, the Company expects it will continue to take pricing actions with respect to its products. Gross margins could also be affected by the Company's ability to effectively manage product quality and warranty costs and to stimulate demand for certain of its products. The Company's operating strategy and pricing take into account anticipated changes in foreign currency exchange rates over time; however, the Company's results of operations can be significantly affected in the short-term by fluctuations in exchange rates.

The Company orders components for its products and builds inventory in advance of product shipments. Because the Company's markets are volatile and subject to rapid technology and price changes, there is a risk the Company will forecast incorrectly and produce or order from third-parties excess or insufficient inventories of particular products or components. 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 outstanding purchase commitments and to respond to short-term shifts in customer demand patterns.

Operating Expenses

Operating expenses for the three and nine months ended June 28, 2003 and June 29, 2002 were as follows (in millions, except for percentages):

	Three Months Ended		Nine Months Ended	
	6/28/03	6/29/02	6/28/03	6/29/02
Research and development	\$ 120	\$ 106	\$ 360	\$ 330
Percentage of net sales	7.8%	7.4%	8.0%	7.7%
Selling, general, and administrative expenses	\$ 299	\$ 272	\$ 898	\$ 831
Percentage of net sales	19.4%	19.0%	20.0%	19.3%
Restructuring costs	\$ —	\$ —	\$ 26	\$ 24

Research and Development (R&D)

Expenditures for research and development increased 13% and 9% for the three and nine month periods ending in June of 2003 compared to the same periods in 2002. These increases were primarily the result of increased R&D headcount to support expanded R&D activities. The Company has continued to expand R&D even though its net sales and profitability are under pressure. The Company has historically relied upon innovation to remain competitive. The Company's management believes that maintaining or increasing the pace of innovation and product development is the best way to respond to current economic and market conditions and will better position the Company for future growth when conditions improve.

Selling, General, and Administrative Expense (SG&A)

SG&A increased 10% and 8% during the third quarter of 2003 and for the first nine months of fiscal 2003, respectively, as compared to the same periods in 2002. Increased SG&A is primarily the result of increased selling expenses associated with the expanded operations of the Company's Retail segment partially offset by a decline in discretionary spending on marketing and advertising and by savings resulting from the restructuring activities described below.

Restructuring Costs

During the second quarter of 2003, the Company's management approved and initiated restructuring actions that resulted in recognition of a total restructuring charge of \$2.8 million. The primary focus of actions taken in the second quarter were for the most part supplemental to actions initiated in the prior two quarters and focused on further headcount reductions in various sales and marketing functions in the Company's Americas and Europe operating segments and further reductions associated with PowerSchool-related activities in the Americas operating segment. The second quarter actions resulted in recognition of severance costs of \$2.4 million for termination of 93 employees, 87 of who were terminated prior to the end of the third quarter of 2003 at a cost of \$2.1 million. During the second quarter of 2003, an additional \$400,000 was accrued for asset write-offs and lease payments on an abandoned facility in the Americas operating segment. Once fully implemented, the Company estimates these restructuring actions will reduce quarterly operating expenses by \$1.5 million.

During the first quarter of 2003, the Company's management approved and initiated restructuring actions with a total cost of \$24 million that resulted in the termination of manufacturing operations at the Company-owned facility in Singapore, further reductions in headcount resulting from the shift in PowerSchool product strategy that took place at the end of fiscal 2002, and termination of various sales and marketing activities in the United States and Europe. These restructuring actions will ultimately result in the elimination of 260 positions worldwide, all but one of which were eliminated by the third quarter of 2003. Once fully implemented, the Company estimates these restructuring actions will reduce quarterly operating expenses by \$6 million.

During the first quarter of 2002, the Company's management approved and initiated restructuring actions with a total cost of approximately \$24 million. These restructuring actions resulted in the elimination of approximately 425 positions worldwide at a cost of \$8 million. Positions were eliminated primarily in the Company's operations, information systems, and administrative functions. In addition, these restructuring actions also included significant changes in the Company's information systems strategy resulting in termination of equipment leases and cancellation of existing projects and activities. Related lease and contract cancellation charges totaled \$12 million, and charges for asset impairments totaled \$4 million. During the first quarter of 2003, the Company reversed the remaining unused accrual of \$600,000. The first quarter 2002 restructuring actions were primarily related to corporate activity not allocated to operating segments and have eliminated approximately \$8.5 million of quarterly operating expenses.

Other Income and Expense

Other income and expense for the three and nine month periods ended June 28, 2003 and June 29, 2002 was as follows (in millions):

	Three Months Ended		Nine Months Ended	
	6/28/03	6/29/02	6/28/03	6/29/02
Gains on non-current investments, net	\$ 2	—	\$ 2	\$ 23
Interest income	\$ 15	\$ 29	\$ 56	\$ 92
Interest expense	(2)	(2)	(6)	(8)
Gain on sales of short term investments, net	3	2	21	5
Other income (expense), net	(1)	(3)	(4)	(2)
Interest and other income, net	15	26	67	87
Total interest and other income, net	<u>\$ 17</u>	<u>\$ 26</u>	<u>\$ 69</u>	<u>\$ 110</u>

Gains and Losses on Non-current Investments

During the third quarter of 2003, the Company sold 278,000 shares of ARM Holdings plc (ARM) stock for net proceeds of approximately \$295,000, and a gain before taxes of \$270,000. During the third quarter of 2003, the Company also sold 3,960,000 shares of EarthLink, Inc. (EarthLink) stock for net proceeds of approximately \$23 million, and a gain before taxes of \$2 million. During the first quarter of 2003, the Company sold 2,580,000 shares of EarthLink stock for net proceeds of approximately \$13.7 million, an amount that approximated the Company's carrying value of the shares sold.

During the first quarter of 2002, the Company sold 4.7 million shares of ARM stock for both net proceeds and a gain before taxes of \$21 million. During the first quarter of 2002, the Company also sold 250,000 shares of Akamai Technologies, Inc. (Akamai) and 117,000 shares of EarthLink stock for net proceeds of approximately \$2 million each and a gain before taxes of \$710,000 and \$223,000, respectively.

Interest and Other Income, Net

Total interest and other income, net decreased \$9 million or 35% to \$17 million during the third quarter of 2003 compared to the same quarter in 2002 and decreased \$41 million or 37% for the first nine months of 2003 from the same period in 2002. These decreases are attributable primarily to declining investment yields on the Company's cash and short-term investments resulting from lower market interest rates and the closing out of longer-term investments in favor of investments with shorter maturities. Declines in investment yields were partially offset by gains on the sale of short-term investments. The Company occasionally sells short-term investments prior to their stated maturities. The sale of short-term investments during the first nine months of 2003 was intended to shorten the average maturity of the Company's investment portfolio based on management's belief that interest rates are at or near their bottom. As a result of such sales, the Company recognized net gains of \$3 million during the third quarter of 2003 and \$2 million during the third quarter of 2002. Such gains were \$21 million and \$5 million during the first nine months of fiscal 2003 and 2002, respectively.

Interest expense consists primarily of interest on the Company's \$300 million aggregate principal amount unsecured notes partially offset by amortization of deferred gains realized in 2002 and 2001 that resulted from the closure of swap positions associated with the unsecured notes. The unsecured notes, which mature in February of 2004, were sold at 99.925% of par for an effective yield to maturity of 6.51%. Total deferred gain resulting from the closure of debt swaps of approximately \$23 million, \$7 million of which remained unamortized as of June 28, 2003, is being amortized over the remaining life of the unsecured notes at a rate of approximately \$2.8 million per quarter.

As noted above, the Company currently expects interest and other income, net to decline significantly during the fourth quarter of 2003 to approximately \$10 million as the impact of declining interest rates and the repositioning of the Company's cash portfolio to shorter-term maturities impact earnings on the Company's investment portfolio. The foregoing statements are forward-looking. Interest and other income, net, in the fourth quarter of 2003 could differ from expected 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.” Additionally, actual future interest and other income, net could be significantly impacted by unforeseen changes in market interest rates and foreign currency exchange rates, by sales of short-term investments, and by future changes in the fair value of the Company’s short-term and long-term investments.

Provision for Income Taxes

The Company’s effective tax rate for the three and nine-month periods ended June 28, 2003 was approximately 28%. The Company’s 2003 effective rate differs from the statutory federal income tax rate of 35% due primarily to certain undistributed foreign earnings for which no U.S. taxes have been provided because such earnings will be indefinitely reinvested outside the U.S. and due to the research and development credit.

As noted above, the Company currently believes that its effective tax rate for the remainder of fiscal 2003 will be approximately 28%. The foregoing statement is forward-looking. The Company’s future tax rate could differ because of several factors, including those set forth below in the subsection entitled “Factors That May Affect Future Results and Financial Condition.” The Company’s actual future tax rate may be impacted by the amount and jurisdiction of foreign profits or any changes to applicable tax laws and regulations.

On April 10, 2003, the Internal Revenue Service (IRS) completed its audit of the Company’s federal income tax returns for the years 1998 through 2000 and proposed certain adjustments. Certain of these adjustments are being contested through the IRS Appeals Office. Substantially all IRS audit issues for years prior to 1998 have been resolved. 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.

Recent Accounting Pronouncements

On May 15, 2003, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards (SFAS) No. 150, *Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity*. SFAS No. 150 requires issuers to classify as liabilities (or assets in some circumstances) three classes of freestanding financial instruments that embody obligations for the issuer. Generally, SFAS No. 150 is effective for financial instruments entered into or modified after May 31, 2003 and is otherwise effective at the beginning of the first interim period beginning after June 15, 2003. The Company expects to adopt the provisions of SFAS No. 150 on June 29, 2003. Adoption of SFAS No. 150 is expected to result in a favorable cumulative effect type adjustment of approximately \$3 million, all of which is related to a forward repurchase agreement that requires the Company to acquire 1.5 million shares of its common stock in September of 2003 at an average price of \$16.64 per share for a total cost of \$25.5 million. Any fluctuation in the fair value of this forward repurchase agreement that occurs prior to its maturity in September 2003 will be reflected in other income and expense.

In January 2003, the FASB issued Interpretation No. 46 (FIN 46), *Consolidation of Variable Interest Entities*. FIN 46 clarifies the application of Accounting Research Bulletin No. 51 and applied immediately to any variable interest entities created after January 31, 2003 and to variable interest entities in which an interest is obtained after that date. For variable interest entities created or acquired prior to February 1, 2003, the provisions of FIN 46 must be applied for the first interim or annual period beginning after June 15, 2003. While it will continue to evaluate the requirements of FIN 46, the Company does not currently believe adoption will have a material impact on its results of operations or financial position.

In November 2002, the FASB issued Interpretation No. 45 (FIN 45), *Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*. FIN 45 requires that a liability be recorded in the guarantor’s balance sheet upon issuance of a guarantee. In addition, FIN 45 requires disclosures about the guarantees that an entity has issued, including a reconciliation of changes in the entity’s product warranty liabilities. The initial recognition and initial measurement provisions of FIN 45 are applicable on a prospective basis to guarantees issued or modified after December 31, 2002. The disclosure requirements of FIN 45 are effective for financial statements of interim or annual periods ending after December 15, 2002. The Company has adopted the disclosure requirements for its financial statements included in this Form 10-Q. The provisions related to recognizing a liability at inception of the guarantee do not apply to product warranties or to indemnification provisions in the Company’s software license arrangements. However, the accounting profession and regulatory agencies continue to discuss various provisions of this pronouncement with the objective of providing

additional guidance on its application. These discussions and the issuance of any new interpretations, once finalized, could lead to an unanticipated impact on the Company's future financial results. Therefore, although the Company currently does not believe these provisions will have a material effect on its operating results or financial position, it will continue to evaluate the impact of FIN 45. Currently, the only significant guarantees issued by the Company to third parties within the scope of FIN 45 are formal product warranty arrangements the Company has with its customers and indemnification provisions that exist in certain of the Company's software license agreements.

In November 2002, the EITF reached a consensus on Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables*. EITF Issue No. 00-21 provides guidance on how to account for certain arrangements that involve the delivery or performance of multiple products, services and/or rights to use assets. The provisions of EITF Issue No. 00-21 will apply to revenue arrangements entered into in fiscal periods beginning after June 15, 2003. While the Company will continue to evaluate the requirements of EITF Issue No. 00-21, management does not currently believe adoption of the standard as written will have a significant impact on its accounting for multiple element arrangements. However, the EITF has recently indicated it is considering clarifying/changing how the scope provisions of EITF 00-21 and SOP No. 97-2, *Software Revenue Recognition* are to be applied in determining which standard applies to multiple element transactions involving both software and non-software components. The Company applies the requirements of SOP No. 97-2 when accounting for such multiple element transactions. The Company will assess the impact, if any, of changes to the scope provisions of either standard when and if such changes occur.

Liquidity and Capital Resources

The following table presents selected financial information and statistics for each of the fiscal quarters ending on the dates indicated (dollars in millions):

	As of 6/28/03	As of 9/28/02
Cash, cash equivalents, and short-term investments	\$ 4,545	\$ 4,337
Accounts receivable, net	\$ 568	\$ 565
Inventory	\$ 38	\$ 45
Working capital	\$ 3,521	\$ 3,730
Days sales in accounts receivable (a)	33	36
Days of supply in inventory (b)	3	4
Days payables outstanding (c)	72	77
Operating cash flow (quarterly)	\$ 8	\$ 82

(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 June 28, 2003, the Company had \$4.545 billion in cash, cash equivalents, and short-term investments, an increase of \$208 million over the same balances at the end of fiscal 2002. The principal components of this increase were cash generated by operating activities of \$216 million, proceeds of \$36 million from the sales of non-current investments, and proceeds of \$31 million from the issuance of common stock, partially offset by capital expenditures of \$106 million.

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.

Lease Commitments

As of September 28, 2002, the Company had total outstanding commitments on noncancelable operating leases of \$464 million, \$209 million of which related to the lease of retail space and related facilities. Remaining terms on the Company's existing operating leases range from 1 to 12 years. Total outstanding commitments on noncancelable operating leases related to the lease of retail space and related facilities rose to \$304 million as of June 28, 2003.

Debt

The Company currently has debt outstanding in the form of \$300 million of aggregate principal amount 6.5% unsecured notes that was originally issued in 1994. The notes, which pay interest semiannually, were sold at 99.925% of par, for an effective yield to maturity of 6.51%. The notes, along with approximately \$7 million of unamortized deferred gains on closed interest rate swaps, are due in February of 2004 and therefore have been classified as current debt as of June 28, 2003. The Company currently anticipates utilizing its existing cash balances to settle these notes when due.

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 1 to 3 months. 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 130 days. The nature of the Company's outstanding third-party manufacturing commitments and component purchase commitments has not changed significantly since the end of its fiscal 2002.

Capital Expenditures

The Company's total capital expenditures were \$106 million during the first nine months of fiscal 2003, \$60 million of which were for retail store facilities and equipment related to the Company's Retail segment and \$46 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 \$160 million for capital expenditures during 2003, approximately \$85 million of which is expected to be utilized for further 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 through the end of fiscal 2000, the Company had repurchased a total of 5.05 million shares at a cost of \$191 million. No shares have been repurchased since the end of fiscal 2000. During the fourth quarter of 2001, the Company entered into a forward purchase agreement to acquire 1.5 million shares of its common stock in September of 2003 at an average price of \$16.64 per share for a total cost of \$25.5 million.

Non-Current Debt and Equity Investments

The Company has held significant investments in ARM, Akamai, and EarthLink. These investments have been reflected in the consolidated balance sheets as non-current debt and equity investments and categorized as available-for-sale requiring that they be carried at fair value with unrealized gains and losses, net of taxes, reported in equity as a component of accumulated other comprehensive income. All realized gains on the sale of these investments have been included in other income. With the exception of approximately 2.9 million shares of Akamai common stock, all such investments have been sold prior to June 28, 2003. The fair value of the Company's remaining investment in Akamai as of June 28, 2003, was approximately \$14 million. The Company believes it is likely there will continue to be significant fluctuations in the fair value of this investment in the future.

Additional information related to the Company's non-current debt and equity investments may be found in this Form 10-Q in the Notes to Condensed Consolidated Financial Statements at Note 2, "Financial Instruments," and in the 2002 Form 10-K.

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 Company.

The Company's operating performance depends significantly on general economic conditions. For much of the past 3 years, demand for the Company's products has been negatively impacted by worsening global economic conditions. Additionally, some of the Company's education customers appear to be delaying technology purchases due to concerns about the overall impact of the weaker economy on their available funding. Continued uncertainty about future economic conditions continues to make it difficult to forecast future operating results. Should global and regional economic conditions fail to improve or continue to deteriorate, demand for the Company's products could continue to be adversely affected, as could the financial health of its suppliers, distributors, and resellers.

The terrorist attacks that took place on September 11, 2001, disrupted commerce throughout the world and created many economic and political uncertainties that have had a strong negative impact on the global economy. The long-term effects of the September 11, 2001 attacks on the Company's future operating results and financial condition remain unknown. The national and international responses to terrorist attacks, the potential for future terrorist attacks and other acts of hostility, and the potential for further war in the Middle East and elsewhere have created economic and political uncertainties that could adversely affect the Company's future operating results and financial condition.

Expansion and/or intensification of the outbreak of severe acute respiratory syndrome (SARS) in Asia and elsewhere could negatively affect the Company's operations and performance.

The SARS outbreak has so far had only a minor effect on the Company. The Company temporarily restricted nonessential employee travel to various areas impacted by the illness during parts of the second and third quarters of fiscal 2003 and formed an internal management committee to closely monitor the situation. The Company experienced weakness in net sales in specific areas affected by the illness and experienced some increase in freight costs as airlines reduced service to certain areas. To date, these conditions have not had a material adverse impact on the Company's financial results or general operations. However, should the illness recur, spread to new regions in Asia or elsewhere, or intensify in areas already affected, the Company's operating results could be adversely impacted.

The Company and some of its manufacturing vendors and component suppliers have significant operations in various locations throughout Asia, including locations in mainland China, the Hong Kong Special Administrative Region, and Singapore, all of which have been subject to World Health Organization and Centers for Disease Control and Prevention SARS travel advisories at times during the second and third quarters of fiscal 2003. Similar travel advisories were issued for Taiwan, where substantially all of the Company's portable Macintosh systems and the iPod are assembled. Should the illness spread further or should it intensify in regions already affected, circumstances could arise that would negatively impact the Company including the need for more stringent employee travel restrictions, additional limitations in the availability of freight services within Asia and between Asia and other regions, 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 market for personal computers is highly competitive. If the Company is unable to effectively compete in this market, 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, continual improvement in product price/performance characteristics, 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 has been particularly intense. The Company's competitors who sell Windows-based personal computers have aggressively cut prices and lowered their product margins in order to gain or maintain market share in response to weakness in demand for personal computing products that began in the second half of calendar 2000. 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. Additionally, several of the Company's competitors have introduced or announced plans to introduce products that mimic many of the unique design, technical features, and solutions of the Company's products. The Company has many substantial 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 Microsoft's Windows operating systems. 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, including Windows.

The Company has higher research and development and selling, general and administrative costs, as a percentage of revenues, than many of its competitors.

The Company's ability to compete successfully and maintain attractive gross margins is heavily dependent upon its ability to ensure a continuing and timely flow of innovative and competitive products and technology to the marketplace. As a result, the Company incurs higher research and development costs as a percentage of revenue than its competitors who sell Windows-based personal computers. 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 percent 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 must successfully manage frequent product introductions and transitions.

Due to the highly volatile nature of the personal computer industry, which is characterized by dynamic customer demand patterns and rapid technological advances, the Company must continually introduce new products and technologies and enhance existing products in order to remain competitive. 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, the availability of application software for new products, the effective management of inventory levels in line with anticipated product demand, 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 effect that new products will have on its sales or results of operations. This includes the Company's planned introduction of Mac OS X version 10.3 "Panther" and introduction of Power Mac G5 systems planned for the second half of calendar 2003.

During 2001, the Company introduced a new client operating system, Mac OS X, and delivered its first major upgrade, Mac OS X version 10.1. During 2002, the Company delivered another major upgrade, Mac OS X Jaguar. As previously noted, the Company also plans to introduce another major upgrade during the second half of calendar 2003. Inability of the Company to improve the performance and functionality of Mac OS X, advance customer acceptance of the new operating system and its upgrades, or obtain the continued commitment of software developers to transition existing applications to run on Mac OS X or create new applications to run on Mac OS X, may have an adverse impact on the Company's operating results and financial condition.

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

adequate, given the rapid and unpredictable pace of product obsolescence in the computer industry, no assurance can be given that the Company will not incur additional inventory and related charges. In addition, such charges have had, and may again 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, 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 130 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.

Future operating results are dependent upon the Company's ability to obtain a sufficient supply of components, 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 application specific integrated circuits ("ASICs") are currently obtained by the Company from single or limited sources. Some key components (including without limitation DRAM, TFT-LCD flat-panel displays, and optical and magnetic disk drives), 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 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, including rights to music titles sold on the iTunes Music Store, the Company's results of operations and financial condition could be adversely affected.

The Company's ability to produce and market competitive products is also dependent on the ability and desire of IBM and Motorola, the sole suppliers of the PowerPC RISC-based microprocessor for the Company's Macintosh computers, 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 by Intel Corporation and other developers and producers of microprocessors used by personal computers using the Windows operating systems. Further, despite its efforts to educate the marketplace to the contrary, the Company believes that many of its current and potential customers believe that the relatively slower MHz rating or clock speed of the microprocessors it utilizes in its Macintosh systems compares unfavorably to those utilized by Windows-based systems and translates to slower overall system performance. There have been instances in recent years where the inability of the Company's suppliers to provide advanced PowerPC G4 and G3 microprocessors with higher clock speeds in sufficient quantity has had significant adverse effects on the Company's results of operations. The inability in the future of the Company to obtain microprocessors in sufficient quantities with competitive price/performance features could have an adverse impact on the Company's results of operations and financial condition.

The Company is dependent on manufacturing and logistics services provided by third parties, many of whom are located outside of the United States.

Many 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 fixed 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 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 or 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 conducted in the Company's manufacturing facilities in Sacramento, California, and Cork, Ireland, and by external vendors in Fremont, California, Fullerton, California, Taiwan, Korea, the People's Republic of China, and the Czech Republic. Currently, manufacture of many of the components used in the Company's products and final assembly of substantially all of the Company's portable products including PowerBooks, iBooks, and the iPod is performed by third-party vendors in Taiwan. If for any reason manufacturing or logistics in any of these locations is disrupted by regional economic, business, environmental, medical, political, or military conditions or events, the Company's results of operations and financial condition could be adversely affected.

The Company's products could experience quality problems that result in decreased net sales and operating profits.

The Company sells highly complex hardware and software products that may contain defects in design and manufacture. Sophisticated operating system software and applications such as the Company sells often contains "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 that may be beyond its control. 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 revenues, loss of reputation, and significant expense to remedy.

The Company's retail initiative requires a substantial investment and commitment of resources and is subject to numerous risks and uncertainties.

Through June 2003, the Company has opened 59 retail stores in the United States and anticipates opening more stores during the remainder of calendar 2003. 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 14 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, should the Retail segment experience a decline in sales for any reason, significant losses would result.

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 three such stores and has others under development. 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 commitments per location over the lease terms ranging from \$25 million to \$50 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; lack of consumer acceptance of the Company's retail approach; 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; 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.

Unit sales of the Company's professionally oriented desktop systems have declined sharply over past two to three years negatively impacting net sales and gross margin.

Unit sales of Power Macintosh systems fell 18% during 2002 as compared to 2001 and fell 35% in 2001 from 2000. Power Macintosh unit sales have fallen as a percentage of total Macintosh unit sales from 38% in 1999 to 25% in 2002 and 20% during the first nine months of fiscal 2003. The Company believes that weak economic conditions over the past several years are having a pronounced negative impact on its professional and creative customers who are the primary users of such systems. The Company also believes that many of these customers continue to delay upgrades of their Power Macintosh systems due to the Company's ongoing transition to Mac OS X and in anticipation of certain software vendors transitioning their professionally oriented Macintosh software applications to run natively in Mac OS X. Also, it is likely that many of the Company's current and potential customers, particularly professional and creative customers who are most likely to utilize the Company's Power Macintosh systems, believe that the relatively slower MHz rating or clock speed of the microprocessors it utilizes in its Macintosh systems compares unfavorably to those utilized by Windows-based systems and translates to slower overall system performance. In addition to the negative impact on net sales, declining sales of Power Macintosh systems also have a negative effect on the Company's overall gross margin because Power Macintosh systems generally have higher individual gross margins than the Company's other Macintosh systems. Continued deterioration in Power Macintosh unit sales will adversely affect the Company's future net sales and gross margin. If future unit sales of Power Macintosh systems fail to partially or fully recover, it will be difficult for the Company to improve its overall profitability. While the Company has announced plans to introduce faster Power Macintosh systems utilizing 64-bit PowerPC G5 processors, there can be no assurance that introduction of such systems will favorably impact net sales either in the short or long term.

The Company faces increasing competition in the U.S. education market.

Sales in the United States to both elementary and secondary schools, as well as for college and university customers, remain a core market for Apple. Net sales in these markets fell to 21% of the Company's total net sales in 2002 from 26% in 2001. The drop in 2002 reflects declines in both net sales and Macintosh unit sales in these markets of 15% and 14%, respectively, in fiscal 2002 compared to 2001. Additionally, the Company experienced a 3% decline in net sales in its U.S. education channel during the first nine months of 2003 as compared to the same period in 2002. Industry data shows that the Company lost market share in the U.S. education market in both fiscal 2002 and 2001. While the Company experienced unit sales growth of 5% in its U.S. education channel during the third quarter of 2003 compared to the same period in 2002, which may indicate the Company has regained some market share during the quarter, total unit sales in U.S. education did decline by 2% during the first nine months of 2003 compared to the same period in 2002. Several competitors of the Company have either targeted or announced their intention to target the education market for personal computers. Although the Company 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 its share of the education market or maintain its existing share of that market. Failure to increase or maintain market share in the education market may have an adverse impact on the Company's operating results and financial condition.

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 a variety of resellers including wholesalers, national and regional retailers and cataloguers, many of who distribute products from competing manufacturers. In addition, the Company also 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. The Company also sells its own products and certain third-party products through its retail stores in the United States. Many of the Company's significant resellers operate on narrow product margins and have been negatively affected by current economic conditions. 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 weakened, 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.

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 United States. The Company's resellers may perceive this expansion of the Company's direct sales as conflicting with their own business 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.

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 relates 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, strengthening in these and other foreign currencies can increase the cost to the Company of product components, negatively affecting the Company's results of operations.

Margins on sales of Apple 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.

Further information related to the Company's global market risks may be found in Part I, Item 3 of this Form 10-Q under the subheading "Foreign Currency Risk," and also in the 2002 Form 10-K.

The Company's future performance is dependent upon support from third-party software developers.

The Company believes that decisions by customers to purchase the Company's personal computers, as opposed to Windows-based systems or other devices, 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. This analysis is based on factors such as the perceived strength of the Company and its products, the anticipated potential revenue that may be generated, acceptance by customers of Mac OS X, and the costs of developing such software products. To the extent the Company's financial losses in prior years and the minority market share held by the Company in the personal computer market, as well as the Company's decision to end its Mac OS licensing program, have 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. Moreover, there can be no assurance software developers will continue to develop software for Mac OS X, the Company's new operating system, on a timely basis or at all.

In addition, past and future development by the Company of its own software applications and solutions may negatively impact the decision of software developers 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 decision 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, consumer digital video and digital photo editing and management, digital music management, desktop-based database management, 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.

In August 1997, the Company and Microsoft Corporation entered into patent cross license and technology agreements. In addition, for a period of five years through August 2002, and subject to certain limitations related to the number of Macintosh computers sold by the Company, Microsoft was required to make versions of its Microsoft Office and Internet Explorer products for the Mac OS. Although Microsoft has released Microsoft Office and Internet Explorer for Mac OS X, Microsoft is not obligated to produce future versions of its products subsequent to August 2002. While the Company believes its relationship with Microsoft has been and will continue to be beneficial

to the Company and to its efforts to increase the installed base for the Mac OS, the Company does compete directly with Microsoft in a number of key areas. Accordingly, Microsoft's interest in producing application software for the Mac OS following expiration of the agreements may be influenced by Microsoft's perception of its interests as the vendor of the Windows operating system. Discontinuance of Microsoft Office and other Microsoft products for the Macintosh platform would have an adverse effect on the Company's net sales and results of operations. In June of 2003, Microsoft stated that it would no longer develop new versions of Internet Explorer for the Mac OS. Microsoft's decision to discontinue development of Internet Explorer for Mac OS X appears to have been influenced in part by the Company's introduction during 2003 of its own web browser, Safari. It is unclear what impact, if any, Microsoft's decision to cease further development of Internet Explorer for Mac OS X will have on the Company. However, if customers chose not to purchase the Company's products because Internet Explorer is not available on the Macintosh platform or should websites fail to provide support for web browsers other than Internet Explorer, the Company's net sales and results of operations could be materially adversely affected.

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 industry, 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 potential litigation involving the Company related to alleged patent infringement and other matters is set forth in Part I, Item 3 of the 2002 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 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 I, Item 3 of the 2002 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 expects its quarterly revenues and operating results to fluctuate for a variety of reasons.

The Company's profit margins vary among its products and its distribution channels. As a result, the overall profitability of the Company in any given period will depend, in part, on the product, geographic, and channel mix reflected in that period's net sales.

The typical concentration of net sales in the third month of the Company's fiscal quarters can adversely affect the Company's business and operating results.

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. 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 or components suppliers, can have significant adverse impacts on the Company and its results of operations and financial condition.

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 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 employees are located. There can be no assurance that the Company will be able to successfully attract and retain the key personnel it needs. Additionally, volatility or a lack of positive performance in the Company's stock price may adversely affect its ability to retain key employees.

The Company is subject to risks associated with the availability and cost of insurance.

The Company has observed rapidly changing conditions in the insurance markets relating to nearly all areas of traditional corporate insurance. Such conditions have resulted in higher premium costs, higher policy deductibles, and lower coverage limits. For some risks, because of cost and/or availability, the Company does not have insurance coverage. For these reasons, the Company is retaining a greater portion of its insurable risks than it has in the past at relatively greater cost.

The Company is exposed to credit risk on its accounts receivable. This risk is heightened as 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 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. While the Company has procedures in place to monitor and limit exposure to credit risk on its trade and non-trade receivables, 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 market value of the Company's non-current debt and equity investments is subject to significant volatility.

The Company has held minority investments in several public companies. As of June 28, 2003, the Company continued to hold an investment in Akamai Technologies, Inc. with a fair market value of approximately \$14 million. Akamai Technologies, Inc. is a publicly traded company whose share price is subject to significant volatility. The Company has categorized its investment in Akamai as available-for-sale requiring it be carried at fair value, with unrealized gains and losses, net of taxes, reported as a component of accumulated other comprehensive income. The Company recognizes an impairment charge to earnings when it is judged an investment has experienced a decline in value that is other-than-temporary. The Company has recognized material impairment charges related to its non-current debt and equity investments twice in the last two fiscal years.

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 that the Company provide consumers with the ability to return product to the Company at the end of its useful life, and place responsibility for environmentally safe disposal or recycling with the Company. 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.

The parliament of the European Union has finalized the Waste Electrical and Electronic Equipment Directive (the Directive). The Directive makes producers of electrical goods, including personal computers, financially responsible for the collection, recycling, and safe disposal of past and future products. The Directive must now be approved and implemented by individual European Union governments by August 13, 2004, while the producers' financial obligations are scheduled to start August 13, 2005. The Company's potential liability resulting from the Directive related to past sales of its products and expenses associated with future sales of its product may be substantial. However, because it is likely that specific laws, regulations, and enforcement policies will vary significantly between individual European member states, it is not currently possible to estimate the Company's existing liability or future expenses resulting from the Directive. As the European Union and its individual member states clarify specific requirements and policies with respect to the Directive, the Company will continue to assess its potential financial

impact. Similar legislation may be enacted in other geographies, including federal and state legislation in the United States, the cumulative impact of which could be significant.

Business interruptions could adversely affect the Company's future operating results.

The Company's major business operations are subject to interruption by earthquake, fire, power shortages, terrorist attacks and other hostile acts, labor disputes, medical conditions, and other events beyond its control. The majority of the Company's research and development activities, its corporate headquarters, and other critical business operations, including certain major components suppliers and manufacturing vendors, are located near major seismic faults. 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.

Unanticipated 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 unanticipated 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.

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. In addition, the stock market has experienced extreme price and volume fluctuations that have affected the market price of many technology companies in ways that have been unrelated to the operating performance of these companies. These factors, as well as 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 common stock in the future.

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 2002 Form 10-K.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

The Company's market risk profile has not changed significantly from that described in the 2002 Form 10-K.

Interest Rate and Foreign Currency Risk Management

To ensure the adequacy and effectiveness of the Company's foreign exchange and interest rate hedge positions, as well as to monitor the risks and opportunities of the non-hedge portfolios, 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, respectively, from both an accounting and an economic perspective. However, given the effective horizons of the Company's risk management activities and the anticipatory nature of the exposures intended to be hedged, there can be no assurance the aforementioned programs will offset more than a portion of the adverse financial impact resulting from unfavorable 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. The Company adopted Statement of Financial Accounting Standard No. 133, Accounting for Derivative Instruments and Hedging Activities (SFAS No. 133), as of October 1, 2000. SFAS No. 133 established accounting and reporting standards for derivative instruments, hedging activities, and exposure definition. Management does not believe that ongoing application of SFAS No. 133 will significantly alter the Company's hedging strategies. However, its application may increase the volatility of other income and expense and other comprehensive income.

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 fixed income 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.

During 1994, the Company issued \$300 million aggregate principal amount of 6.5% unsecured notes in a public offering registered with the SEC. The notes were sold at 99.925% of par, for an effective yield to maturity of 6.51%. The notes pay interest semiannually and mature on February 15, 2004.

The Company's exposure to market risk for changes in interest rates relates primarily to the Company's investment portfolio and long-term debt obligations and related derivative financial instruments. 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 June 28, 2003, \$338 million of the Company's investment portfolio that was classified as short-term investments had maturities ranging from 1 to 5 years. As of September 28, 2002, \$1.087 billion of the Company's investment portfolio that was classified as short-term investments had maturities ranging from 1 to 5 years. The remainder of such short-term investments had underlying maturities of between 3 and 12 months. Due to liquidity needs, or in anticipation of credit deterioration, or for the purpose of duration management of the Company's investment portfolio, the Company may sell investments prior to their stated maturities. As a result of such activity, the Company recognized net gains of \$3 million and \$21 million during the three and nine month periods ended June 28, 2003, respectively.

The Company sometimes enters into interest rate derivative transactions, including interest rate swaps, collars, and floors, with financial institutions in order to better match the Company's floating-rate interest income on its cash equivalents and short-term investments with its fixed-rate interest expense on its long-term debt, and/or to diversify a

portion of the Company's exposure away from fluctuations in short-term U.S. interest rates. The Company may also enter into interest rate contracts that are intended to reduce the cost of the interest rate risk management program. The Company entered into no interest rate asset swaps during 2002 or for the first nine months of 2003 and had no open interest rate asset swaps at June 28, 2003.

During the last two years, the Company has entered into interest rate swaps with financial institutions in order to better match the Company's floating-rate interest income on its cash equivalents and short-term investments with its fixed-rate interest expense on its long-term debt, and/or to diversify a portion of the Company's exposure away from fluctuations in short-term U.S. interest rates. The interest rate swaps, which qualified as accounting hedges, generally required the Company to pay a floating interest rate based on the three- or six-month U.S. dollar LIBOR and receive a fixed rate of interest without exchanges of the underlying notional amounts. These swaps effectively converted the Company's fixed-rate 10-year debt to floating-rate debt and converted a portion of the floating rate investments to fixed rate. Due to prevailing market interest rates, during 2002 the Company entered into and then subsequently closed out debt swap positions realizing a gain of \$6 million. During 2001 the Company closed out all of its then existing debt swap positions realizing a gain of \$17 million. Both the gains in 2002 and 2001 were deferred, recognized in long-term debt and are being amortized to other income and expense over the remaining life of the debt. At certain times in the past, the Company has also entered into interest rate contracts that are intended to reduce the cost of the interest rate risk management program. The Company does not hold or transact in such financial instruments for purposes other than risk management.

Foreign Currency Risk

Overall, the Company is a net receiver of currencies other than the U.S. dollar and, as such, generally benefits from a weaker dollar and is adversely affected by a stronger dollar relative to major currencies worldwide. 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 within the time frame of our hedged positions due to competitive pressures when there has been significant volatility in foreign currency exchange rates.

The Company enters into foreign currency forward and option contracts with financial institutions primarily to protect against foreign exchange risks associated with existing assets and liabilities, certain firmly committed transactions, and probable but not firmly committed transactions. 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. The Company also enters into foreign currency forward and option contracts to offset the foreign exchange gains and losses generated by the re-measurement of certain recorded assets and liabilities denominated in non-functional currencies of its foreign subsidiaries.

Item 4. Controls and Procedures

Based on an evaluation under the supervision and with the participation of the Company's management as of a date within 90 days of the filing date of this Quarterly Report on Form 10-Q, 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-14(c) and 15d-14(c) under the Securities Exchange Act of 1934, as amended (*Exchange Act*)) are effective to ensure that information required to be disclosed by the Company in reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms.

There were no significant changes in the Company's internal controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation. There were no significant deficiencies or material weaknesses identified, and therefore there were no corrective resulting actions taken. However, the design of any system of controls is based in part upon certain assumptions about the likelihood of future events and there is no certainty that any design will succeed in achieving its stated goal under all potential future considerations.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

The Company is subject to various legal proceedings and claims that are discussed below and/or in the 2002 Form 10-K. 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 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.

Pitney Bowes Inc. v. Apple Computer, Inc.

Plaintiff Pitney Bowes filed this patent infringement action on June 18, 2001 alleging patent infringement relating to laser printer technology. Plaintiff filed similar lawsuits against other companies. Plaintiff sought unspecified damages and other relief. The Company answered the complaint, denying all allegations and asserting numerous affirmative defenses. The Company settled this matter during the second quarter of 2003 for an amount that did not have a material adverse effect on its financial condition, liquidity or results of operations.

Hawaii Structural Iron Workers and Pension Trust Fund v. Apple Computer, Inc. and Steven P. Jobs; Young v. Apple Computer, Inc. et al; Hsu v. Apple Computer Inc. et al

Beginning on September 27, 2001, three shareholder class action lawsuits were filed in the United States District Court for the Northern District of California against the Company and its Chief Executive Officer. These lawsuits are substantially identical, and purport to bring suit on behalf of persons who purchased the Company's publicly traded common stock between July 19, 2000, and September 28, 2000. The complaints allege violations of the 1934 Securities Exchange Act and seek unspecified compensatory damages and other relief. The Company believes these claims are without merit and intends to defend them vigorously. The Company filed a motion to dismiss on June 4, 2002, which was heard by the Court on September 13, 2002. On December 11, 2002, the Court granted the Company's motion to dismiss for failure to state a cause of action, with leave to plaintiffs to amend their complaint. Plaintiffs filed their amended complaint on January 31, 2003, and on March 17, 2003, the Company filed a motion to dismiss the amended complaint. A hearing on the Company's motion was held on July 11, 2003, and the Court has yet to issue a ruling on the matter.

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

The annual meeting of shareholders was held on April 24, 2003. Proposals I, II, III, IV and V were approved. The results are as follows:

Proposal I

The following directors were elected at the meeting to serve a one-year term as directors:

	<u>For</u>	<u>Authority Withheld</u>
William V. Campbell	239,627,912	65,728,547
Millard S. Drexler	241,239,341	64,117,118
Albert Gore, Jr.	286,268,250	19,088,209
Steven P. Jobs	244,409,513	60,946,946
Arthur D. Levinson	239,711,322	65,645,137
Jerome B. York	241,560,389	63,796,070

Proposal II

The proposal to amend the Company's Employee Stock Purchase Plan to increase the number of shares of Common Stock reserved for issuance thereunder by 4,000,000 shares.

<u>For</u>	<u>Against</u>	<u>Abstained</u>
295,611,636	7,565,725	2,179,098

Proposal III

The proposal to amend the Company's 1998 Executive Officer Stock Plan (the 1998 Plan) to allow for broad-based grants to all employees.

<u>For</u>	<u>Against</u>	<u>Abstained</u>
270,547,870	32,539,900	2,268,689

Proposal IV

Ratification of appointment of KPMG LLP as the Company's independent auditors for fiscal year 2003.

<u>For</u>	<u>Against</u>	<u>Abstained</u>
296,780,091	6,520,075	2,056,293

Proposal V

A shareholder proposal requesting that the Board of Directors establish a policy of expensing in the Company's annual income statement the cost of all future stock options issued by the Company.

<u>For</u>	<u>Against</u>	<u>Abstained</u>	<u>Broker Non-Vote</u>
116,337,358	90,028,640	18,180,032	98,625,086

The proposals above are described in detail in the Registrant's definitive proxy statement dated March 24, 2003, for the Annual Meeting of Shareholders held on April 24, 2003.

Item 6. Exhibits and Reports on Form 8-K

(a) Index to Exhibits

Exhibit Number	Exhibit Description	Incorporated by Reference		Filed herewith
		Form	Date	
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 March 19, 2003.	10-Q	5/13/03	
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 24, 2003.	S-8	6/24/03	
10.A.8	Form of Indemnification Agreement between the Registrant and each officer of the Registrant.	10-K	9/26/97	
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 Option Plan, as amended through April 24, 2003.			✓
10.A.52	Reimbursement Agreement.	10-Q	6/29/02	
10.A.53	Option Cancellation and Restricted Stock Award Agreement.			✓
10.B.8	Participation in the Customer Design Center by the Registrant dated as of September 30, 1991 between IBM and the Registrant.	8-K	10/91	
10.B.9	Agreement for Purchase of IBM Products (Original Equipment Manufacturer) dated as of September 30, 1991 between IBM and the Registrant.	8-K	10/91	
10.B.12	Microprocessor Requirements Agreement dated January 31, 1992 between the Registrant and Motorola, Inc.	10-K	9/25/92	
10.B.16	Fountain Manufacturing Agreement dated May 31, 1996 between Registrant and SCI Systems, Inc.	10-Q	8/12/96	
99.1	Certificate of Apple Computer, Inc. Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.			✓

(b) Reports on Form 8-K

The Company filed a current report on Form 8-K on July 16, 2003, to reference and furnish as exhibits a press release and data sheet issued to the public by the Company on July 16, 2003.

The Company filed a current report on Form 8-K on April 18, 2003, to reference and furnish as exhibits a press release and data sheet issued to the public by the Company on April 16, 2003.

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.

APPLE COMPUTER, INC.
(Registrant)

By: /s/ Fred D. Anderson

Fred D. Anderson
Executive Vice President and Chief Financial Officer
August 12, 2003

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 quarterly 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 quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly 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 quarterly report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
 - a) designed such disclosure controls and procedures 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 quarterly report is being prepared;
 - b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
 - c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, 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 in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

August 12, 2003

By: /s/ Steven P. Jobs
Steven P. Jobs
Chief Executive Officer

APPLE COMPUTER, INC.
2003 Employee Stock Option Plan
(April 24, 2003)

1. **Purposes of the Plan.** The purposes of this Stock Plan are:

- to attract and retain the best available personnel
- to provide additional incentive to Employees and the Chairman; and
- to promote the success of the Company's business.

Options granted under the Plan may be Incentive Stock Options (as defined under Section 422 of the Code) or Nonstatutory Stock Options, as determined by the Administrator at the time of grant. Stock appreciation rights ("SARs") may be granted under the Plan in connection with Options or independently of Options. Stock Purchase Rights may also be granted under the Plan.

2. **Definitions.** As used herein, the following definitions shall apply:

(a) **"Administrator"** means the Board or any of its Committees as shall be administering the Plan, in accordance with Section 4 of the Plan.

(b) **"Agreement"** means an agreement between the Company and an Optionee evidencing the terms and conditions of an individual Option, SAR or Stock Purchase Right grant. The Agreement is subject to the terms and conditions of the Plan.

(c) **"Applicable Laws"** means the requirements relating to the administration of stock option plans under U.S. state corporate laws, U.S. federal and state securities laws, the Code, any stock exchange or quotation system on which the Common Stock is listed or quoted and the applicable laws of any foreign country or jurisdiction where Options, SARs or Stock Purchase Rights are, or will be, granted under the Plan.

(d) **"Board"** means the Board of Directors of the Company.

- (e) “*Chairman*” means the Chairman of the Board.
- (f) “*Code*” means the Internal Revenue Code of 1986, as amended.
- (g) “*Committee*” means a committee of Directors appointed by the Board in accordance with Section 4 of the Plan.
- (h) “*Common Stock*” means the common stock of the Company.
- (i) “*Company*” means Apple Computer, Inc., a California corporation.

(j) “*Continuous Status as Chairman*” unless determined otherwise by the Administrator, means the absence of any interruption or termination as Chairman of the Board with the Company. Continuous Status as Chairman shall not be considered interrupted in the case of medical leave, military leave, family leave, or any other leave of absence approved by the Administrator, provided, in each case, that such leave does not result in termination as Chairman with the Company. Neither service as a Director nor payment of a director’s fee by the Company shall be sufficient to constitute status as “Chairman” by the Company.

(k) “*Continuous Status as an Employee*” means the absence of any interruption or termination of the employment relationship with the Company or any Subsidiary. Continuous Status as an Employee shall not be considered interrupted in the case of (i) medical leave, military leave, family leave, or any other leave of absence approved by the Administrator, provided, in each case, that such leave does not result in termination of the employment relationship with the Company or any Subsidiary, as the case may be, under the terms of the respective Company policy for such leave; however, vesting may be tolled while an employee is on an approved leave of absence under the terms of the respective Company policy for such leave; or (ii) in the case of transfers between locations of the Company or between the Company, its Subsidiaries, or its successor. For purposes of Incentive Stock Options, no such leave may exceed ninety days, unless reemployment upon expiration of such leave is guaranteed by statute or contract. If reemployment upon expiration of a leave of absence approved by the Company is not so guaranteed, on the 91st day of such leave any Incentive Stock Option held by the Optionee shall cease to be treated as an Incentive Stock Option and shall be treated for tax purposes as a Nonstatutory Stock Option. Neither service as a Chairman nor as a Director nor payment of a director’s fee by the Company shall be sufficient to constitute “employment” by the Company.

- (l) “*Director*” means a member of the Board.

(m) “*Employee*” means any person employed by the Company or any Parent or Subsidiary of the Company subject to (k) above.

(n) “*Exchange Act*” means the Securities Exchange Act of 1934, as amended.

(o) “*Fair Market Value*” means, as of any date, the value of Common Stock determined as follows:

(i) If the Common Stock is listed on any established stock exchange or a national market system, including without limitation the Nasdaq National Market or The Nasdaq SmallCap Market of The Nasdaq Stock Market, its Fair Market Value shall be the closing sales price for such stock (or the closing bid, if no sales were reported) as quoted on such exchange or system, on the date of determination or, if the date of determination is not a trading day, the immediately preceding trading day, as reported in *The Wall Street Journal* or such other source as the Administrator deems reliable;

(ii) If the Common Stock is regularly quoted by a recognized securities dealer but selling prices are not reported, the Fair Market Value of a Share of Common Stock shall be the mean between the high bid and low asked prices for the Common Stock on the date of determination or, if there are no quoted prices on the date of determination, on the last day on which there are quoted prices prior to the date of determination, as reported in *The Wall Street Journal* or such other source as the Administrator deems reliable; or

(iii) In the absence of an established market for the Common Stock, the Fair Market Value shall be determined in good faith by the Administrator.

(p) “*Incentive Stock Option*” means an Option intended to qualify as an incentive stock option within the meaning of Section 422 of the Code and the regulations promulgated thereunder and is expressly designated by the Administrator at the time of grant as an incentive stock option.

(q) “*Nonstatutory Stock Option*” means an Option not intended to qualify as an Incentive Stock Option.

(r) “*Option*” means a stock option granted pursuant to the Plan.

(s) “*Optioned Stock*” means the Common Stock subject to an Option, SAR or Stock Purchase Right.

(t) “*Optionee*” means the holder of an outstanding Option, SAR or Stock Purchase Right.

- (u) “*Parent*” means a “parent corporation,” whether now or hereafter existing, as defined in Section 424(e) of the Code.
- (v) “*Plan*” means this 2003 Employee Stock Option Plan.
- (w) “*Restricted Stock*” means shares of Common Stock acquired pursuant to a grant of Stock Purchase Rights under Section 12 of the Plan.
- (x) “*Rule 16b-3*” means Rule 16b-3 of the Exchange Act or any successor to Rule 16b-3, as in effect when discretion is being exercised with respect to the Plan.
- (y) “*SAR*” means a stock appreciation right granted pursuant to Section 10 below.
- (z) “*Section 16(b)*” means Section 16(b) of the Exchange Act.
- (aa) “*Share*” means a share of the Common Stock, as adjusted in accordance with Section 15 of the Plan.
- (bb) “*Stock Purchase Right*” means the right to purchase Common Stock pursuant to Section 12 of the Plan, as evidenced by an Agreement.
- (cc) “*Subsidiary*” means a “subsidiary corporation”, whether now or hereafter existing, as defined in Section 424(f) of the Code.

3. ***Stock Subject To The Plan.*** Subject to the provisions of Section 15 of the Plan, the maximum aggregate number of Shares which may be optioned and sold under the Plan or for which SARs or Stock Purchase Rights may be granted and exercised is 48,000,000 Shares. The Shares may be authorized, but unissued, or reacquired Common Stock.

In the discretion of the Administrator, any or all of the Shares authorized under the Plan may be subject to SARs issued pursuant to the Plan.

If an Option, SAR or Stock Purchase Right issued under the Plan should expire or become unexercisable for any reason without having been exercised in full, the unpurchased Shares which were subject thereto shall become available for other Options, SARs or Stock Purchase Rights under this Plan (unless the Plan has terminated); however, should the Company reacquire Shares which were issued pursuant to the exercise of an Option or SAR, such Shares shall not become available for future grant under the Plan. If Shares of Restricted Stock are repurchased by the Company at their original purchase price, such shares

shall become available for future grant under the Plan.

4. ***Administration of the Plan.***

(a) *Procedure.*

(i) *Multiple Administrative Bodies.* If permitted by Rule 16b-3 promulgated under the Exchange Act or any successor rule thereto, as in effect at the time that discretion is being exercised with respect to the Plan, and by the legal requirements of the Applicable Laws relating to the administration of stock plans such as the Plan, if any, the Plan may (but need not) be administered by different administrative bodies with respect to (A) Directors who are not Employees, (B) Directors who are Employees, (C) Officers who are not Directors and (D) Employees who are neither Directors nor Officers.

(ii) *Section 162(m).* To the extent that the Administrator determines it to be desirable to qualify Options or SARs granted hereunder as “performance-based compensation” within the meaning of Section 162(m) of the Code, the Plan shall be administered by a Committee of two or more “outside directors” within the meaning of Section 162(m) of the Code.

(iii) *Rule 16b-3.* To the extent desirable to qualify transactions hereunder as exempt under Rule 16b-3, the transactions contemplated hereunder shall be structured to satisfy the requirements for exemption under Rule 16b-3.

(iv) *Other Administration.* Other than as provided above, the Plan shall be administered by (A) the Board or (B) a Committee, which committee shall be constituted to satisfy Applicable Laws.

(b) *Powers of the Administrator.* Subject to the provisions of the Plan, and in the case of a Committee, subject to the specific duties delegated by the Board to such Committee, the Administrator shall have the authority, in its discretion:

(i) to determine the Fair Market Value;

(ii) to select the person(s) to whom Options, SARs and Stock Purchase Rights may be granted hereunder;

(iii) to determine the number of shares of Common Stock to be covered by each Option, SAR or Stock Purchase Right granted hereunder;

(iv) to approve forms of agreement for use under the Plan;

(v) to determine the terms and conditions, not inconsistent with the terms of the Plan, of any Option, SAR or Stock Purchase Right granted hereunder. Such terms and conditions include, but are not limited to, the exercise price, the date of grant, the time or times when Options, SARs or Stock Purchase Rights may be exercised (which may be based on performance criteria), any vesting acceleration or waiver of forfeiture restrictions, and any restriction or limitation regarding any Option, SAR or Stock Purchase Right or the shares of Common Stock relating thereto, based in each case on such factors as the Administrator, in its sole discretion, shall determine;

(vi) to reduce the exercise price of any Option, SAR or Stock Purchase Right to the then current Fair Market Value if the Fair Market Value of the Common Stock covered by such Option, SAR or Stock Purchase Right shall have declined since the date the Option, SAR or Stock Purchase Right was granted; however, the Administrator may not “reprice” options, including 6-months-plus-1-day option exchange programs, without shareholder approval.

(vii) to construe and interpret the terms of the Plan and awards granted pursuant to the Plan;

(viii) to prescribe, amend and rescind rules and regulations relating to the Plan, including rules and regulations relating to sub-plans established for the purpose of qualifying for preferred tax treatment under foreign tax laws;

(ix) to modify or amend each Option, SAR or Stock Purchase Right (subject to Section 17(c) of the Plan), including the discretionary authority to extend the post-termination exercisability period of Options longer than is otherwise provided for in the Plan;

(x) to allow Optionees to satisfy withholding tax obligations by electing to have the Company withhold from the Shares to be issued upon exercise of an Option, SAR or Stock Purchase Right that number of Shares having a Fair Market Value equal to the amount required to be withheld. The Fair Market Value of the Shares to be withheld shall be determined on the date that the amount of tax to be withheld is to be determined. All elections by an Optionee to have Shares withheld for this purpose shall be made in such form and under such conditions as the Administrator may deem necessary or advisable;

(xi) to authorize any person to execute on behalf of the Company any instrument required to effect the grant of an Option, SAR or Stock Purchase Right previously granted by the Administrator; and

(xii) to make all other determinations deemed necessary or advisable for administering the Plan.

(c) *Effect of Administrator's Decision.* The Administrator's decisions, determinations and interpretations shall be final and binding on all Optionees and any other holders of Options, SARs or Stock Purchase Rights.

5. **Eligibility.** Nonstatutory Stock Options, SARs and Stock Purchase Rights may be granted to Employees and the Chairman or to such other individuals as

determined by the Administrator whom the Company has offered a position of Chairman or Employee. Incentive Stock Options may be granted only to Employees.

6. **Limitations.**

(a) Each Option shall be designated in the Agreement as either an Incentive Stock Option or a Nonstatutory Stock Option. However, notwithstanding such designation, to the extent that the aggregate Fair Market Value of the Shares with respect to which Incentive Stock Options are exercisable for the first time by the Optionee during any calendar year (under all plans of the Company and any Parent or Subsidiary) exceeds \$100,000, such Options shall be treated as Nonstatutory Stock Options. For purposes of this Section 6(a), Incentive Stock Options shall be taken into account in the order in which they were granted. The Fair Market Value of the Shares shall be determined as of the time the Option with respect to such Shares is granted.

(b) Neither the Plan nor any Option, SAR or Stock Purchase Right shall confer upon an Optionee any right with respect to continuing the Optionee's relationship as an Employee with or Chairman of the Company, nor shall they interfere in any way with the Optionee's right or the Company's right to terminate such relationship at any time, with or without cause.

(c) The following limitations shall apply to grants of Options and SARs:

(i) No participant shall be granted, in any fiscal year of the Company, Options or SARs to purchase more than 34,000,000 Shares;

(ii) The foregoing limitations shall be adjusted proportionately in connection with any change in the Company's capitalization as described in Section 15;

(iii) If an Option or SAR is canceled in the same fiscal year of the Company in which it was granted (other than in connection with a transaction described in Section 15), the canceled Option will be counted against the limits set forth in subsections (i) above. For this purpose, if the exercise price of an Option or SAR is reduced, the transaction will be treated as a cancellation of the Option or SAR and the grant of a new Option or SAR.

7. **Term of Plan.** Subject to Section 21 of the Plan, the Plan shall become effective upon its adoption by the Board. It shall continue in effect for a term of ten (10) years unless terminated earlier under Section 16 of the Plan.

8. **Term of Option.** The term of each Option shall be stated in the Agreement. In the case of an Incentive Stock Option, the term shall be ten (10) years from the date of grant or such shorter term as may be provided in the

Agreement. Moreover, in the case of an Incentive Stock Option granted to an Optionee who, at the time the Incentive Stock Option is granted, owns stock representing more than ten percent (10%) of the total combined voting power of

all classes of stock of the Company or any Parent or Subsidiary, the term of the Incentive Stock Option shall be five (5) years from the date of grant or such shorter term as may be provided in the Agreement.

9. ***Option Exercise Price and Consideration.***

(a) *Exercise Price.* The per share exercise price for the Shares to be issued pursuant to exercise of an Option shall be determined by the Administrator, subject to the following:

(i) In the case of an Incentive Stock Option;

(A) granted to an Employee who, at the time the Incentive Stock Option is granted, owns stock representing more than ten percent (10%) of the voting power of all classes of stock of the Company or any Parent or Subsidiary, the per Share exercise price shall be no less than 110% of the Fair Market Value per Share on the date of grant; or

(B) granted to any Employee other than an Employee described in paragraph (A) immediately above, the per Share exercise price shall be no less than 100% of the Fair Market Value per Share on the date of grant;

(ii) In the case of a Nonstatutory Stock Option, the per Share exercise price shall be determined by the Administrator. In the case of a Nonstatutory Stock Option intended to qualify as “performance-based compensation” within the meaning of Section 162(m) of the Code, the per Share exercise price shall be no less than 100% of the Fair Market Value per Share on the date of grant;

(iii) Notwithstanding the foregoing, Options may be granted with a per Share exercise price of less than 100% of the Fair Market Value per Share on the date of grant as determined by the Administrator or pursuant to a merger or other corporate transaction.

(b) *Waiting Period and Exercise Dates.* At the time an Option is granted, the Administrator shall fix the period within which the Option may be exercised and shall determine any conditions which must be satisfied before the Option may be exercised.

(c) *Form of Consideration.* The Administrator shall determine the acceptable form of consideration for exercising an Option, including the method of payment. In the case of an Incentive Stock Option, the Administrator shall determine the acceptable form of consideration at the time of grant. Such consideration may consist entirely of:

- (i) cash;
- (ii) check;
- (iii) promissory note;
- (iv) other Shares which (A) in the case of Shares acquired upon exercise of an option, have been owned by the Optionee for more than six months on the date of surrender, and (B) have a Fair Market Value on the date of surrender equal to the aggregate exercise price of the Shares as to which said Option shall be exercised;
- (v) consideration received by the Company under a cashless exercise program implemented by the Company in connection with the Plan;
- (vi) a reduction in the amount of any Company liability to the Optionee, including any liability attributable to the Optionee's participation in any Company-sponsored deferred compensation program or arrangement;
- (vii) any combination of the foregoing methods of payment; or
- (viii) such other consideration and method of payment for the issuance of Shares to the extent permitted by Applicable Laws.

10. ***Stock Appreciation Rights.***

(a) *Granted in Connection with Options.* At the sole discretion of the Administrator, SARs may be granted in connection with all or any part of an Option, either concurrently with the grant of the Option or at any time thereafter during the term of the Option. The following provisions apply to SARs that are granted in connection with Options:

- (i) The SAR shall entitle the Optionee to exercise the SAR by surrendering to the Company unexercised a portion of the related Option. The Optionee shall receive in exchange from the Company an amount equal to the excess of (x) the Fair Market Value on the date of exercise of

the SAR of the Common Stock covered by the surrendered portion of the related Option over (y) the exercise price of the Common Stock covered

by the surrendered portion of the related Option. Notwithstanding the foregoing, the Administrator may place limits on the amount that may be paid upon exercise of a SAR; provided, however, that such limit shall not restrict the exercisability of the related Option;

(ii) When a SAR is exercised, the related Option, to the extent surrendered, shall no longer be exercisable;

(iii) A SAR shall be exercisable only when and to the extent that the related Option is exercisable and shall expire no later than the date on which the related Option expires; and

(iv) A SAR may only be exercised at a time when the Fair Market Value of the Common Stock covered by the related Option exceeds the exercise price of the Common Stock covered by the related Option.

(b) *Independent SARs.* At the sole discretion of the Administrator, SARs may be granted without related Options. The following provisions apply to SARs that are not granted in connection with Options:

(i) The SAR shall entitle the Optionee, by exercising the SAR, to receive from the Company an amount equal to the excess of (x) the Fair Market Value of the Common Stock covered by exercised portion of the SAR, as of the date of such exercise, over (y) the Fair Market Value of the Common Stock covered by the exercised portion of the SAR, as of the date on which the SAR was granted; provided, however, that the Administrator may place limits on the amount that may be paid upon exercise of a SAR; and

(ii) SARs shall be exercisable, in whole or in part, at such times as the Administrator shall specify in the Optionee's Agreement.

(c) *Form of Payment.* The Company's obligation arising upon the exercise of a SAR may be paid in Common Stock or in cash, or in any combination of Common Stock and cash, as the Administrator, in its sole discretion, may determine. Shares issued upon the exercise of a SAR shall be valued at their Fair Market Value as of the date of exercise.

(d) *Rule 16b-3.* SARs granted hereunder shall contain such additional restrictions as may be required to be contained in the Plan or Agreement in order for the SAR to qualify for the maximum exemption provided by Rule 16b-3.

11. ***Exercise of Option or SAR.***

(a) *Procedure for Exercise; Rights as a Shareholder.* Any Option or SAR granted hereunder shall be exercisable according to the terms of the Plan and at such times and under such conditions as determined by the Administrator and set forth in the Agreement. An Option may not be exercised for a fraction of a Share.

An Option or SAR shall be deemed exercised when the Company receives: (i) written or electronic notice of exercise (in accordance with the terms of the Option or SAR) from the person entitled to exercise the Option or SAR, and (ii) full payment for the Shares with respect to which the Option is exercised. Full payment may consist of any consideration and method of payment authorized by the Administrator and permitted by the Agreement and the Plan. Shares issued upon exercise of an Option shall be issued in the name of the Optionee or, if requested by the Optionee, in the name of the Optionee and his or her spouse. Until the Shares are issued (as evidenced by the appropriate entry on the books of the Company or of a duly authorized transfer agent of the Company), no right to vote or receive dividends or any other rights as a shareholder shall exist with respect to the Optioned Stock, notwithstanding the exercise of the Option. The Company shall issue (or cause to be issued) such Shares promptly after the Option is exercised. No adjustment will be made for a dividend or other right for which the record date is prior to the date the Shares are issued, except as provided in Section 15 of the Plan.

Exercising an Option in any manner shall decrease the number of Shares thereafter available, both for purposes of the Plan and for sale under the Option, by the number of Shares as to which the Option is exercised. Exercise of a SAR in any manner shall, to the extent the SAR is exercised, result in a decrease in the number of Shares which thereafter shall be available for purposes of the Plan, and the SAR shall cease to be exercisable to the extent it has been exercised.

(b) *Termination of Continuous Status as Chairman.* Upon termination of an Optionee's Continuous Status as Chairman (other than termination by reason of the Optionee's death), the Optionee may, but only within ninety (90) days after the date of such termination, exercise his or her Option or SAR to the extent that it was exercisable at the date of such termination. Notwithstanding the foregoing, however, an Option or SAR may not be exercised after the date the Option or SAR would otherwise expire by its terms due to the passage of time from the date of grant.

(c) *Termination of Continuous Employment.* Upon termination of an Optionee's Continuous Status as Employee (other than termination by reason of

the Optionee's death), the Optionee may, but only within ninety (90) days after the date of such termination, exercise his or her Option or SAR to the extent that

it was exercisable at the date of such termination. Notwithstanding the foregoing, however, an Option or SAR may not be exercised after the date the Option or SAR would otherwise expire by its terms due to the passage of time from the date of grant.

(d) *Death of Optionee.* If an Optionee dies (i) while an Employee or Chairman, the Option or SAR may be exercised at any time within six (6) months (or such other period of time not exceeding twelve (12) months as determined by the Administrator) following the date of death by the Optionee's estate or by a person who acquired the right to exercise the Option by bequest or inheritance, but only to the extent of the right to exercise that would have accrued had the Optionee continued living and terminated his or her employment six (6) months (or such other period of time not exceeding twelve (12) months as determined by the Administrator) after the date of death; or (ii) within ninety (90) days after the termination of Continuous Status as an Employee or Chairman, the Option or SAR may be exercised, at any time within six (6) months (or such other period of time not exceeding twelve (12) months as determined by the Administrator) following the date of death by the Optionee's estate or by a person who acquired the right to exercise the Option or SAR by bequest or inheritance, but only to the extent of the right to exercise that had accrued at the date of termination. If the Option or SAR is not so exercised within the time specified herein, the Option or SAR shall terminate, and the Shares covered by such Option or SAR shall revert to the Plan.

Notwithstanding the foregoing, however, an Option or SAR may not be exercised after the date the Option or SAR would otherwise expire by its terms due to the passage of time from the date of grant.

(e) *Buyout Provisions.* The Administrator may at any time offer to buy out for a payment in cash or Shares an Option or SAR previously granted based on such terms and conditions as the Administrator shall establish and communicate to the Optionee at the time that such offer is made.

12. ***Stock Purchase Rights.***

(a) *Rights to Purchase.* Stock Purchase Rights may be issued either alone, in addition to, or in tandem with other awards granted under the Plan and/or cash awards made outside of the Plan. After the Administrator determines that it will offer Stock Purchase Rights under the Plan, it shall advise the Optionee in writing or electronically, of the terms, conditions and restrictions related to the offer, including the number of Shares that the Optionee shall be entitled to purchase, the price to be paid, and the time within which the Optionee must accept such offer. The offer shall be accepted by execution of an

Agreement in the form determined by the Administrator.

(b) *Repurchase Option.* Unless the Administrator determines otherwise, the Agreement shall grant the Company a repurchase option exercisable upon the voluntary or involuntary termination of the purchaser's service with the Company for any reason (including death or Disability). The purchase price for Shares repurchased pursuant to the Agreement shall be the original price paid by the purchaser and may be paid by cancellation of any indebtedness of the purchaser to the Company. The repurchase option shall lapse at a rate determined by the Administrator.

(c) *Other Provisions.* The Agreement shall contain such other terms, provisions and conditions not inconsistent with the Plan as may be determined by the Administrator in its sole discretion.

(d) *Rights as a Shareholder.* Once the Stock Purchase Right is exercised, the purchaser shall have the rights equivalent to those of a shareholder, and shall be a shareholder when his or her purchase is entered upon the records of the duly authorized transfer agent of the Company. No adjustment will be made for a dividend or other right for which the record date is prior to the date the Stock Purchase Right is exercised, except as provided in Section 15 of the Plan.

13. *Transferability of Options, SARs and Stock Purchase Rights.* Unless determined otherwise by the Administrator, an Option, SAR or Stock Purchase Right may not be sold, pledged, assigned, hypothecated, transferred, or disposed of in any manner other than by will or by the laws of descent or distribution or pursuant to a qualified domestic relations order as defined by the Code or Title 1 of the Employee Retirement Income Security Act, and may be exercised, during the lifetime of the Optionee, only by the Optionee. If the Administrator makes an Option, SAR or Stock Purchase Right transferable, such Option, SAR or Stock Purchase Right shall contain such additional terms and conditions as the Administrator deems appropriate.

14. *Stock Withholding to Satisfy Withholding Tax Obligations.* When an Optionee incurs tax liability in connection with the exercise of an Option, SAR or Stock Purchase Right, which tax liability is subject to tax withholding under applicable tax laws, and the Optionee is obligated to pay the Company an amount required to be withheld under applicable tax laws, the Optionee may satisfy the withholding tax obligation by electing to have the Company withhold from the Shares to be issued upon exercise of the Option, or the Shares to be issued upon exercise of the SAR or Stock Purchase Right, if any, that number of Shares having a Fair Market Value equal to the amount required to be withheld. The Fair Market Value of the Shares to be withheld shall be determined on the date that the amount of tax to be withheld is to be determined (the "Tax Date").

All elections by an Optionee to have Shares withheld for this purpose shall be made in writing in a form acceptable to the Administrator and shall be subject to the following restrictions:

- (a) the election must be made on or prior to the applicable Tax Date; and
- (b) All elections shall be subject to the consent or disapproval of the Administrator.

In the event the election to have Shares withheld is made by an Optionee and the Tax Date is deferred under Section 83 of the Code because no election is filed under Section 83(b) of the Code, the Optionee shall receive the full number of Shares with respect to which the Option, SAR or Stock Purchase Right is exercised but such Optionee shall be unconditionally obligated to tender back to the Company the proper number of Shares on the Tax Date.

15. ***Adjustments Upon Changes in Capitalization, Dissolution, Merger or Asset Sale.***

(a) *Changes in Capitalization.* Subject to any required action by the shareholders of the Company, the number of shares of Common Stock covered by each outstanding Option, SAR or Stock Purchase Right, and the number of shares of Common Stock which have been authorized for issuance under the Plan but as to which no Options, SARs or Stock Purchase Rights have yet been granted or which have been returned to the Plan upon cancellation or expiration of an Option, SAR or Stock Purchase Right, as well as the price per share of Common Stock covered by each such outstanding Option, SAR or Stock Purchase Right, shall be proportionately adjusted for any increase or decrease in the number of issued shares of Common Stock resulting from a stock split, reverse stock split, stock dividend, combination or reclassification of the Common Stock, or any other increase or decrease in the number of issued shares of Common Stock effected without receipt of consideration by the Company; provided, however, that conversion of any convertible securities of the Company shall not be deemed to have been “effected without receipt of consideration.” Such adjustment shall be made by the Board, whose determination in that respect shall be final, binding and conclusive. Except as expressly provided herein, no issuance by the Company of shares of stock of any class, or securities convertible into shares of stock of any class, shall affect, and no adjustment by reason thereof shall be made with respect to, the number or price of shares of Common Stock subject to an Option, SAR or Stock Purchase Right.

(b) *Dissolution or Liquidation.* In the event of the proposed dissolution or liquidation of the Company, all outstanding Options, SARs and Stock Purchase Rights will terminate immediately prior to the consummation of such

proposed action, unless otherwise provided by the Administrator. The Administrator may, in the exercise of its sole discretion in such instances, declare that any Option, SAR or Stock Purchase Right shall terminate as of a date fixed by the Administrator and give each Optionee the right to exercise his or her Option, SAR or Stock Purchase Right as to all or any part of the Optioned Stock, including Shares as to which the Option, SAR or Stock Purchase Right would not otherwise be exercisable.

(c) *Merger or Asset Sale.* Unless otherwise determined by the Administrator, in the event of a merger of the Company with or into another corporation, or the sale of substantially all of the assets of the Company, each outstanding Option, SAR and Stock Purchase Right shall be assumed or an equivalent option or right substituted by the successor corporation or a Parent or Subsidiary of the successor corporation. In the event that the successor corporation refuses to assume or substitute for the Option, SAR or Stock Purchase Right, the Optionee shall fully vest in and have the right to exercise the Option, SAR or Stock Purchase Right as to all of the Optioned Stock, including Shares as to which it would not otherwise be vested or exercisable. If an Option, SAR or Stock Purchase Right becomes fully vested and exercisable in lieu of assumption or substitution in the event of a merger or sale of assets, the Administrator shall notify the Optionee in writing or electronically that the Option, SAR or Stock Purchase Right shall be fully vested and exercisable for a period of thirty (30) days from the date of such notice, and the Option, SAR or Stock Purchase Right shall terminate upon the expiration of such period. For the purposes of this paragraph, the Option, SAR or Stock Purchase Right shall be considered assumed if, following the merger or sale of assets, the option or right confers the right to purchase or receive, for each Share of Optioned Stock subject to the Option, SAR or Stock Purchase Right immediately prior to the merger or sale of assets, the consideration (whether stock, cash, or other securities or property) received in the merger or sale of assets by holders of Common Stock for each Share held on the effective date of the transaction (and if holders were offered a choice of consideration, the type of consideration chosen by the holders of a majority of the outstanding Shares); provided, however, that if such consideration received in the merger or sale of assets is not solely common stock of the successor corporation or its Parent, the Administrator may, with the consent of the successor corporation, provide for the consideration to be received upon the exercise of the Option, SAR or Stock Purchase Right, for each Share of Optioned Stock subject to the Option, SAR or Stock Purchase Right, to be solely common stock of the successor corporation or its Parent equal in fair market value to the per share consideration received by holders of Common Stock in the merger or sale of assets.

(d) *Change in Control.* In the event of a “Change in Control” of the Company, as defined in paragraph (e) below, unless otherwise determined by

the Administrator prior to the occurrence of such Change in Control, the following acceleration and valuation provisions shall apply:

(i) Any Options, SARs and Stock Purchase Rights outstanding as of the date such Change in Control is determined to have occurred that are not yet exercisable and vested on such date shall become fully exercisable and vested; and

(ii) The value of all outstanding Options, SARs and Stock Purchase Rights shall, unless otherwise determined by the Administrator at or after grant, be cashed-out. The amount at which such Options, SARs and Stock Purchase Rights shall be cashed out shall be equal to the excess of (x) the Change in Control Price (as defined below) over (y) the exercise price of the Common Stock covered by the Option, SAR or Stock Purchase Right. The cash-out proceeds shall be paid to the Optionee or, in the event of death of an Optionee prior to payment, to the estate of the Optionee or to a person who acquired the right to exercise the Option, SAR or Stock Purchase Right by bequest or inheritance.

(e) *Definition of "Change in Control"*. For purposes of this Section 15, a "Change in Control" means the happening of any of the following:

(i) When any "person", as such term is used in Sections 13(d) and 14(d) of the Exchange Act (other than the Company, a Subsidiary or a Company employee benefit plan, including any trustee of such plan acting as trustee) is or becomes the "beneficial owner" (as defined in Rule 13d-3 under the Exchange Act), directly or indirectly, of securities of the Company representing fifty percent (50%) or more of the combined voting power of the Company's then outstanding securities; or

(ii) The occurrence of a transaction requiring shareholder approval, and involving the sale of all or substantially all of the assets of the Company or the merger of the Company with or into another corporation.

(f) *Change in Control Price*. For purposes of this Section 15, "Change in Control Price" shall be, as determined by the Administrator, (i) the highest Fair Market Value at any time within the 60-day period immediately preceding the date of determination of the Change in Control Price by the Administrator (the "60-Day Period"), or (ii) the highest price paid or offered, as determined by the Administrator, in any bona fide transaction or bona fide offer related to the Change in Control of the Company, at any time within the 60-Day Period.

16. ***Date of Grant.*** The date of grant of an Option, SAR or Stock Purchase Right shall be, for all purposes, the date on which the Administrator makes the determination granting such Option, SAR or Stock Purchase Right, or such other later date as is determined by the Administrator. Notice of the determination shall be provided to each Optionee within a reasonable time after the date of such grant.

17. ***Amendment and Termination of the Plan.***

(a) ***Amendment and Termination.*** The Board may at any time amend, alter, suspend or terminate the Plan.

(b) ***Shareholder Approval.*** The Company shall obtain shareholder approval of any Plan amendment to the extent necessary and desirable to comply with Applicable Laws.

(c) ***Effect of Amendment or Termination.*** No amendment, alteration, suspension or termination of the Plan shall impair the rights of any Optionee, unless mutually agreed otherwise between the Optionee and the Administrator, which agreement must be in writing and signed by the Optionee and the Company. Termination of the Plan shall not affect the Administrator's ability to exercise the powers granted to it hereunder with respect to Options, SARs or Stock Purchase Rights granted under the Plan prior to the date of such termination.

18. ***Conditions Upon Issuance of Shares.***

(a) ***Legal Compliance.*** Shares shall not be issued pursuant to the exercise of an Option, SAR or Stock Purchase Right unless the exercise of such Option, SAR or Stock Purchase Right and the issuance and delivery of such Shares shall comply with Applicable Laws and shall be further subject to the approval of counsel for the Company with respect to such compliance.

(b) ***Investment Representations.*** As a condition to the exercise of an Option, SAR or Stock Purchase Right, the Company may require the person exercising such Option, SAR or Stock Purchase Right to represent and warrant at the time of any such exercise that the Shares are being purchased only for investment and without any present intention to sell or distribute such Shares if, in the opinion of counsel for the Company, such a representation is required.

19. ***Inability to Obtain Authority.*** The inability of the Company to obtain authority from any regulatory body having jurisdiction, which authority is deemed by the Company's counsel to be necessary to the lawful issuance and sale of any Shares hereunder, shall relieve the Company of any liability in

respect of the failure to issue or sell such Shares as to which such requisite authority shall not have been obtained.

20. **Reservation of Shares.** The Company, during the term of this Plan, will at all times reserve and keep available such number of Shares as shall be sufficient to satisfy the requirements of the Plan.

21. **Shareholder Approval.** The Plan shall be subject to approval by the shareholders of the Company within twelve (12) months after the date the Plan is adopted. Such shareholder approval shall be obtained in the manner and to the degree required under Applicable Laws.

22. **Non-U.S. Employees.** Notwithstanding anything in the Plan to the contrary, with respect to any employee who is resident outside of the United States, the Committee may, in its sole discretion, amend the terms of the Plan in order to conform such terms with the requirements of local law or to meet the objectives of the Plan. The Committee may, where appropriate, establish one or more sub-plans for this purpose.

**APPLE COMPUTER, INC.
OPTION CANCELLATION AND
RESTRICTED STOCK AWARD AGREEMENT**

This Agreement is made March 19, 2003 (the "Effective Date"), by and between Apple Computer, Inc. ("Apple") and Steven P. Jobs.

In connection with his services as Chief Executive Officer, Mr. Jobs was granted an option to purchase 20,000,000 shares of Apple common stock on January 20, 2000 and an option to purchase 7,500,000 shares on October 19, 2001 (collectively, the "Options") pursuant to Apple's 1998 Executive Officer Stock Plan (the "1998 Plan").

Mr. Jobs and Apple both desire to cancel the Options in their entirety and Apple desires to grant Mr. Jobs a restricted stock award of 5,000,000 shares of Apple common stock.

Mr. Jobs and Apple agree as follows:

1. Cancellation of Options. The Options shall be cancelled and disposed of to Apple as of the Effective Date. Following such cancellation, Mr. Jobs shall have no rights whatsoever with respect to the Options.
 2. Grant of Restricted Stock. Apple hereby grants to Mr. Jobs as of the Effective Date, a restricted stock award of 5,000,000 shares of Apple common stock (the "Shares") pursuant to the terms and conditions contained herein and the terms and conditions of the 1998 Plan.
 3. Vesting of the Shares.
 - (a) Release Date. One hundred percent (100%) of the Shares shall be vested on March 19, 2006 (the "Release Date") provided that Mr. Jobs has remained continuously employed by Apple, or any parent or subsidiary of Apple, until such date.
 - (b) Termination Without Cause Prior to Release Date. In the event of termination by Apple of Mr. Jobs' employment without "Cause" (as defined below) prior to the Release Date, the Shares shall be fully vested in Mr. Jobs as of such termination date.
 - (c) Termination Due to Death. In the event of termination of employment due to Mr. Jobs' death prior to the Release Date, that number of Shares deemed to have vested on a pro rata daily basis from the Effective Date to the date of death shall be immediately vested in Mr. Jobs as of the date of death and shall be released from the Reacquisition Right described below. The unvested Shares shall remain subject to the Reacquisition Right.
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(d) Resignation for Good Reason Following a Change in Control. In the event there is a “Change in Control” of Apple (as defined in Section 15(d) of the 1998 Plan) and as a consequence of such Change in Control, Mr. Jobs resigns for “Good Reason” (as defined below), the following acceleration provisions shall apply:

- (i) If such Change of Control and subsequent resignation for Good Reason occurs during the first eighteen (18) months following the Effective Date, then 50% of the Shares shall be immediately vested in Mr. Jobs and shall be released from the Reacquisition Right.
- (ii) If such Change of Control and subsequent resignation for Good Reason occurs more than eighteen (18) months after the Effective Date, then 100% of the Shares shall be immediately vested in Mr. Jobs and shall be released from the Reacquisition Right.

(e) Termination for Other Reasons. In the event that Mr. Jobs’ employment with Apple, or any parent or subsidiary of Apple, terminates prior to the Release Date for any reason other than those specified in Sections (b), (c) and (d) above, including termination voluntarily by Mr. Jobs or by Apple for Cause, Apple shall, upon the date of such termination, have an irrevocable, exclusive option (the “Reacquisition Right”) to reacquire the Shares at no cost to the Apple.

(f) Exercise of Reacquisition Right. The Reacquisition Right shall be exercised by Apple by delivering written notice to Mr. Jobs or to Mr. Jobs’ executor within ninety (90) days following the date of termination. Upon delivery of such notice, Apple shall become the legal and beneficial owner of the Shares being reacquired and all rights and interests therein, and Apple shall have the right to retain and transfer to its own name the Shares being reacquired.

(g) Termination of Reacquisition Right. If the Company does not elect to exercise the Reacquisition Right conferred above by giving the requisite notice within ninety (90) days following the termination of Mr. Jobs’ employment by Apple, or any parent or subsidiary of Apple, the Reacquisition Right shall terminate and the Shares shall be fully vested in Mr. Jobs. The Shares released from the Reacquisition Right shall be delivered to Mr. Jobs at his request.

(h) Certain Definitions.

(i) “Cause” For purposes of this Section 3, “Cause” shall mean: (i) a willful act of embezzlement, fraud or dishonesty by Mr. Jobs which is materially injurious to Apple; (ii) Mr. Jobs’ continued violation of his obligation to perform the duties and responsibilities normally required of a chief executive officer which are willful or grossly negligent, after Mr. Jobs has been given written notice from the Apple Board of Directors describing his violations and has failed to cure or commence to cure such violations within thirty (30) days; or (iii) Mr. Jobs’ conviction of, or plea of nolo contendere to, a felony which the Board of

Directors reasonably believes has had or will have a material detrimental effect on Apple's reputation or business.

(ii) "Good Reason." For purposes of this Section 3, "Good Reason" shall mean a resignation by Mr. Jobs of his employment with Apple, or any parent or subsidiary of Apple, as a result of any of the following:

- (a) A meaningful and detrimental alteration of his position, his title, or the nature or status of his responsibilities (including his reporting responsibilities) from those in effect immediately prior to the Change in Control. For purposes of this clause (a), a meaningful and detrimental alteration shall exist if, on or after the Change in Control, Mr. Jobs does not hold the position of Chief Executive Officer of the Company (or the surviving entity resulting from a merger or consolidation of the Company with another entity (the "Surviving Entity") or if there is any adverse change on or after the Change in Control in his title, position or reporting responsibilities;
- (b) A reduction by Apple in Mr. Jobs' annual base salary as in effect immediately prior to the Change in Control or as the same may be increased from time to time thereafter;
- (c) The relocation of the Apple office where Mr. Jobs is employed as of the Change in Control to a location which is more than seventy-five (75) miles away from such office, or a requirement that Mr. Jobs be based more than seventy-five (75) miles away from his Apple office as of the Change in Control.

4. Restriction on Transfer. Mr. Jobs shall not sell, transfer, pledge, hypothecate or otherwise dispose of any Shares prior to the Release Date or any earlier lapse or termination of the Reacquisition Right.

5. Escrow of Shares. Until the Release Date, the Shares will be held in book name by Apple's transfer agent. Subject to the terms hereof, Mr. Jobs shall have all rights of a shareholder with respect to such Shares while they are held in escrow, including without limitation, the right to vote the Shares and receive any cash dividends declared thereon. If, from time to time during the term of the Reacquisition Right, there is (i) any stock dividend, stock split or other change in the Shares, or (ii) any merger or sale of all or substantially all of the assets or other acquisition of Apple, any and all new, substituted or additional securities to which Mr. Jobs is entitled by reason of his ownership of the Shares shall be held on his behalf by the Apple's transfer agent and included thereafter as "Shares" for purposes of this Agreement and the Reacquisition Right.

6. Tax Consequences. Mr. Jobs understands that he (and not Apple) shall be responsible for his own tax liability that may arise as a result of the transactions contemplated by this Agreement. Mr. Jobs understands that Section 83 of the Internal Revenue Code of 1986, as amended (the "Code") taxes as ordinary income the difference between the amount paid for the Shares and the fair market value of the Shares as of the date any restrictions on the Shares lapse. In this context, "restriction" includes the right of Apple to reacquire the Shares pursuant to its Reacquisition Right. Mr. Jobs understands that he may elect to be taxed at the time the Shares are granted rather than when the Reacquisition Right lapses by filing an election under Section 83(b) of the Code with the I.R.S. within 30 days from the date of grant.

7. General Provisions.

- (a) This Agreement and the 1998 Plan represent the entire agreement and understanding between the parties as to the subject matter hereof and supersede all prior or contemporaneous agreements, whether written or oral.
- (b) This Agreement shall be governed by the laws of the State of California without reference to its conflicts of law principles.
- (c) No waiver, alteration or modification of any of the provisions of this Agreement shall be binding, unless in writing and signed by duly authorized representatives of the parties hereto. This Agreement shall be binding on, and shall inure to the benefit of, the parties and their respective successors and assigns.
- (d) This Agreement may be executed in two or more counterparts, each of which shall be deemed an original and all of which together shall constitute one instrument.

IN WITNESS WHEREOF, the parties have duly executed this Agreement effective as of the date set forth above.

APPLE COMPUTER, INC.

By: /s/ Nancy R. Heinen

Its: Senior Vice President

/s/ Steve Jobs

Steven P. Jobs

