AMAZON COM INC
Form 10-K405
January 24, 2002

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

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

For the fiscal year ended December 31, 2001

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 No. 000-22513

AMAZON.COM, INC.

(Exact name of registrant as specified in its charter)

Delaware	**91-1646860**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

P.O. Box 81226
Seattle, Washington 98108-1226
(206) 266-1000
(Address, and telephone number, including area code, of registrant s principal executive offices)

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

None

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

Common Stock, par value $.01 per share

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 x No ¨

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

10-K or any amendment to this Form 10-K. Yes x No ¨

Aggregate market value of voting stock held by non-affiliates of the registrant as of January 10, 2002	$	2,859,000,000
Number of shares of common stock outstanding as of January 10, 2002		373,291,188

DOCUMENTS INCORPORATED BY REFERENCE

The information required by Part III of this Report, to the extent not set forth herein, is incorporated herein by reference from the registrant s definitive proxy statement relating to the annual meeting of stockholders to be held in 2002, which definitive proxy statement shall be filed with the Securities and Exchange Commission within 120 days after the end of the fiscal year to which this Report relates.

AMAZON.COM, INC.

FORM 10-K
For the Fiscal Year Ended December 31, 2001

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PART I

Item 1. *Business*

This Annual Report on Form 10-K and the documents incorporated herein by reference contain forward-looking statements based on expectations, estimates and projections as of the date of this filing. Actual results may differ materially from those expressed in forward-looking statements. See Management s Discussion and Analysis of Financial Condition and Results of Operations Forward-Looking Statements.

General

Amazon.com, Inc. commenced operations on the World Wide Web in July 1995 and seeks to offer Earth s Biggest Selection. We seek to be the world s most customer-centric company, where customers can find and discover anything they may want to buy online. We and our sellers list millions of unique items in categories such as books, music, DVDs, videos, electronics, computers, camera and photo items, software, computer and video games, cell phones and service, tools and hardware, outdoor living items, kitchen and houseware products, toys, baby and baby registry, travel services and magazine subscriptions. Through our Amazon Marketplace, Auctions and zShops services, businesses and individuals can sell virtually any product to our millions of customers, and with Amazon.com Payments, sellers are able to accept credit card transactions in addition to other methods of payment. We operate a U.S.-based Web site, *www.amazon.com*, and four internationally-focused Web sites: *www.amazon.co.uk*, *www.amazon.de*, *www.amazon.fr* and *www.amazon.co.jp*.

Amazon.com was incorporated in 1994 in the state of Washington and reincorporated in 1996 in the state of Delaware. Our principal corporate offices are located in Seattle, Washington. We completed our initial public offering in May 1997, and our common stock is listed on the Nasdaq National Market under the symbol AMZN.

As used herein, Amazon.com, we, our and similar terms include Amazon.com, Inc. and its subsidiaries, unless the context indicates otherwise.

Business Strategy

We seek to offer Earth s Biggest Selection and to be Earth s most customer-centric company, where customers can find and discover anything they may want to buy online. To accomplish our objective, we have developed three sales channels: online retail, marketplace and other, and third-party sellers. Revenue from each sales channel is recorded in one of our four operating segments: U.S. Books, Music and DVD/Video; U.S. Electronics, Tools and Kitchen; Services; and International. Historically, we have focused our sales efforts towards the individual consumer. In 2001, in addition to focusing on the individual consumer, we introduced our corporate and institutional buying program, which allows qualified businesses, libraries, schools, government institutions and other organizations to purchase products and services from our Web site using purchase orders in addition to credit cards or advance payments.

Online Retail. Our online retail stores offer a broad range of categories of new products to our customers. These products include books, music, DVDs, videos, electronics, computers, camera and photo items, software, computer and video games, cell phones and service, tools and hardware, outdoor living items, kitchen and houseware products, and magazine subscriptions. For most new products owned by us and offered on our online retail stores, whether U.S. or international, we purchase the products from vendors and hold them in our fulfillment centers to fulfill orders ourselves; in some cases, we have our vendors fulfill orders on our behalf. We anticipate continuing to expand the range of new online retail stores in the future.

Marketplace and Other. Marketplace and Other consists of Amazon Marketplace, Auctions and zShops, as well as certain of our non-retail Web sites. Marketplace, Auctions and zShops enhance the selection on our Web

sites by offering new products, or used versions of new products we offer in our online retail stores, or offering additional products or services that expand or supplement our retail product offering. Amazon Marketplace permits sellers to utilize our e-commerce seller services and tools to present their product alongside our new product on the same product detail page on our Web site; a single Web page provides the customer a choice between purchasing a new product from us or the new or used product from the Amazon Marketplace seller. Amazon Auctions allows buyers and sellers to conduct transactions in an easy-to-use auction format. zShops allows individuals and businesses to create individual stores to offer popular as well as hard-to-find items to our customers. We also own the Internet Movie Database (*www.imdb.com*), a comprehensive and authoritative source of information on movie and entertainment titles, and cast and crew members.

Third-Party Sellers. The third-party sellers channel allows us to provide other companies a set of e-commerce services and tools for the sale of their goods and services. We have third-party seller arrangements with Toysrus.com, Inc., Target Corporation, Circuit City Stores, Inc., the Borders Group, Waterstones, Expedia, Inc., Hotwire, National Leisure Group, Inc., Virgin Wines, and others. We offer:

Strong global brand recognition;

Web merchandising, including our patented search technologies, personalization, 1-Click ordering, editorial content and customer reviews, and data-driven automation;

Technology infrastructure;

Customer service, including a global 24-hour customer support network, customer self-service technology, and proprietary e-commerce call center technology;

Global fulfillment capabilities fully integrated to a Web site; and

Customer traffic and acquisition involving our millions of customers and our Associates Program.

In 2001, we began marketing three services for third-party sellers that are designed to provide catalog retailers, physical store retailers and manufacturers with cost-effective e-commerce solutions and to expand the selection on our Web sites for the benefit of our customers:

Merchant@amazon.com Program: The third party seller offers its products for sale on our Web site, either in our online retail stores or in a co-branded store on our Web site, or both. Its products are fully integrated on our Web site and are purchased by customers through a single checkout process. The third-party seller is the seller of record and pays us fixed fees, sales commissions, per-unit activity fees, or some combination thereof. In this program, we offer the option of providing fulfillment-related services on behalf of the third-party. Examples include the Toysrus.com toy store and Babiesrus.com baby store at *www.amazon.com*; the Target store at *www.amazon.com*, which is part of our strategic alliance with Target; our strategic alliance with Circuit City; and our strategic alliances that support our travel stores on our U.S. and U.K.-focused Web sites.

Merchant Program: The third-party seller s e-commerce Web site operates at its own URL using our features and technology. In this program, we offer the option of providing fulfillment-related services on behalf of the third-party. We believe this offering will enable third-party sellers to have a high quality e-commerce site at a controllable and competitive cost. The third-party seller is the seller of record and pays us fixed fees, sales commissions, per-unit activity fees, or some combination thereof. An example is our features and technology that will be deployed at Target.com, which is scheduled to re-launch in the second half of 2002.

Syndicated Stores Program: The third-party seller s e-commerce Web site uses our e-commerce services and tools, and offers our product selection. Under these arrangements, we are responsible for fulfillment and we provide customer service. We are the seller of record on these transactions and remit a commission to the third party. Examples include *www.borders.com* and *www.waterstones.co.uk*, both of which were launched in 2001 as Syndicated Stores.

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Operating Segments

Commencing in January 2001, we organized our operations into four principal segments: U.S. Books, Music and DVD/Video; U.S. Electronics, Tools and Kitchen; Services; and International. See Note 16 of Notes to Consolidated Financial Statements included in Item 8 of Part II of this Form 10-K for additional information regarding our segments.

U.S. Books, Music and DVD/Video Segment. This segment includes retail sales from *www.amazon.com* of books, music and DVDs/video products and for magazine subscriptions. This segment also includes commissions from sales of these products, new or used, through Amazon Marketplace and product revenues from stores offering these products through our Syndicated Stores Program, such as *www.borders.com*.

The U.S. Books, Music and DVD/video segment had net sales of $1.69 billion, $1.70 billion, and $1.31 billion in 2001, 2000, and 1999, respectively. In 2001, we added the Look Inside the Book feature, which allows customers to view selected interior pages of thousands of books on our Web site. In addition, we launched our magazine store, where customers can subscribe to more than 600 magazine titles, and our e-documents store, where customers can purchase and download electronic documents.

U.S. Electronics, Tools and Kitchen Segment. This segment includes *www.amazon.com* retail sales of electronics, computers, camera and photo items, software, computer and video games, cell phones and service, tools and hardware, outdoor living items, kitchen and houseware products, toys and video games sold other than through our strategic alliance with Toysrus.com, Inc., as well as catalog sales of toys, tools and hardware. This segment also includes commissions from sales of these products, new or used, through Amazon Marketplace and commissions or other amounts earned from offerings of these products by third-party sellers through our Merchant@amazon.com Program, such as our strategic alliance with Circuit City.

The U.S. Electronics, Tools and Kitchen segment had net sales of $547 million, $484 million, and $151 million in 2001, 2000 and 1999, respectively. During 2001, we launched our computer store, and began our offering of in-store pick-up through our strategic alliance with Circuit City.

Services Segment. This segment consists of commissions, fees and other amounts earned from our business-to-business strategic alliances, including our Merchant Program and, to the extent product categories are not also offered by us through our online retail stores, our Merchant@amazon.com Program, as well as our strategic alliance with America Online, Inc. This segment also includes Auctions, zShops and Payments, and miscellaneous marketing and promotional agreements. Marketing responsibilities associated with successfully promoting the expansion of our third-party seller and other service offerings are placed with our management team leading this segment.

The Services segment had net sales of $225 million, $198 million, and $13 million in 2001, 2000 and 1999, respectively. In 2001, we entered into numerous strategic alliances with such companies as America Online and Target in the U.S., and Virgin Wines in the U.K. We also expanded our product offering under our Toysrus.com strategic alliance to include Babiesrus.com and Imaginarium.com co-branded stores at *www.amazon.com*. In addition, we entered into strategic alliances with Expedia, Hotwire and National Leisure Group to create our travel store.

International Segment. This segment includes all retail sales of our four internationally-focused Web sites: *www.amazon.co.uk*, *www.amazon.de*, *www.amazon.fr* and *www.amazon.co.jp*. These international sites share a common Amazon experience, but are localized in terms of language, products, customer service and fulfillment. This segment includes commissions and other amounts earned from offerings of these products by third party sellers through our Merchant@amazon.com Program, and product revenues from stores offering products through our internationally-focused Syndicated Stores Program, such as *www.waterstones.co.uk*.

Net sales for the International segment (from all internationally-focused sites, including export sales to the U.S.) were $661 million, $381 million, and $168 million in 2001, 2000, and 1999, respectively. In 2001,

www.amazon.co.uk and *www.amazon.de* each launched electronics stores, *www.amazon.fr* launched software and electronic games stores, and *www.amazon.co.jp* launched music, video, DVD, software and electronic games stores. In addition, *www.amazon.co.jp* introduced a new payment method to allow customers to pay with cash upon delivery of their order.

Amazon.com Web Sites

Our Web sites promote brand loyalty and repeat purchases by providing feature-rich content, a secure and trusted transaction environment, and easy-to-use functionality. The key features of our Web sites include broad selection, low prices, availability, convenience, information (including useful product information and reviews and personalized recommendations and notifications), discovery, 1-Click technology, secure payment systems, availability, fulfillment, browsing and searching. Other key features include Web pages tailored to individual customers preferences, and, with our new Look Inside the Book feature, the ability to view selected interior pages of thousands of books. Our Wish List feature allows users to create an online wish list of desired products and services that others can reference for gift-giving purposes, and our Listmania feature allows users to publish lists with accompanying commentary regarding their favorite products on our Web site.

Marketing and Promotion

Our marketing strategy is designed to strengthen and broaden the Amazon brand name, increase customer traffic to our Web sites, build customer loyalty, encourage repeat purchases and develop incremental product and service revenue opportunities. We deliver personalized pages and services and employ a variety of media, business development activities and promotional methods to achieve these goals. We also benefit from public relations activities as well as online and traditional advertising, including radio, television and print media, and direct marketing.

We direct customers to our Web site through our Associates Program, which enables associated Web sites to make products available to their audiences with fulfillment performed by us. Currently, over 700,000 Web sites have enrolled in the Associates Program.

Customer Service

We believe that our ability to establish and maintain long-term relationships with our customers and to encourage repeat visits and purchases depends, in part, on the strength of our customer service operations, and we continually seek to improve the Amazon customer service experience. Users can contact customer service representatives 24 hours a day, seven days a week. We have automated certain tools used by our customer service staff and have plans for further enhancements. We currently have customer service personnel working in six customer service centers located in Tacoma, Washington; Slough, England; Regensburg, Germany; Grand Forks, North Dakota; Huntington, West Virginia; and Sapporo, Japan. In addition, we have customer-service outsourcing arrangements with vendors in India, Northern Ireland, and the U.S., respectively.

Warehousing, Inventory, Fulfillment and Distribution

We currently lease and operate U.S. fulfillment facilities in New Castle, Delaware; Coffeyville, Kansas; Campbellsville and Lexington, Kentucky; Fernley, Nevada; and Grand Forks, North Dakota; as well as a seasonal fulfillment center, used as necessary, in Seattle, Washington. We also lease and operate three European fulfillment centers that are located in the United Kingdom, France and Germany. In Japan, Nippon Express, a leading courier company, provides fulfillment services for orders from *www.amazon.co.jp*. On an aggregate basis, these fulfillment centers comprise approximately 4.0 million square feet of warehouse space. In addition, we lease four off-site facilities that fluctuate from

340,000 to 710,000 square feet of space, which support the storage and fulfillment functions of the U.S. fulfillment centers. Our fulfillment centers facilitate our ability to deliver our merchandise, as well as third-party seller merchandise, to customers on a reliable and timely basis.

Seasonality

Our business is generally affected by both seasonal fluctuations in Internet usage (which generally declines during summer months) and traditional retail seasonality. Traditional retail sales for most of our products, including books, music, DVDs, videos, toys and electronics usually increase significantly in the fourth calendar quarter of each year. In particular, the fourth quarter seasonal effect may be even more pronounced in our sales of toys, which are mainly sold through our strategic alliance with Toysrus.com, and in our sales of electronics, in comparison with our other product categories.

Technology

We have implemented numerous Web-site management, search, customer interaction, recommendation, transaction-processing and fulfillment services and systems using a combination of our own proprietary technologies and commercially available, licensed technologies. Our current strategy is to focus our development efforts on creating and enhancing the specialized, proprietary software that is unique to our business and to license or acquire commercially-developed technology for other applications where available and appropriate.

We use a set of applications for accepting and validating customer orders, placing and tracking orders with suppliers, managing and assigning inventory to customer orders and ensuring proper shipment of products to customers based on various ordering criteria. Our transaction-processing systems handle millions of items, a number of different status inquiries, gift-wrapping requests and multiple shipment methods, and allow the customer to choose whether to receive single or several shipments based on availability and to track the progress of each order. These applications also manage the process of accepting, authorizing and charging customer credit cards. Our Web sites also incorporate a variety of search and database tools and provide personalized features for individual customers such as instant personalized recommendations, personalized notifications and wish lists.

Competition

The online-commerce retail channel is relatively new, rapidly evolving and intensely competitive. In addition, the retail environment for our products is generally intensely competitive. Our current or potential competitors include: (1) physical-world retailers, catalog retailers, publishers, distributors and manufacturers of our products, many of which possess significant brand awareness, sales volume and customer bases, and some of which currently sell, or may sell, products or services through the Internet, mail order or direct marketing; (2) online vendors of products that we sell; (3) a number of indirect competitors, including Web portals and Web search engines that are involved in online commerce, either directly or in collaboration with other retailers; (4) Web-based retailers using alternative-fulfillment capabilities; and (5) companies that provide e-commerce services, including Web-site developers and third-party fulfillment and customer-service providers. We believe that the principal competitive factors in our market segments include selection, price, availability, convenience, information, discovery, brand recognition, personalized services, accessibility, customer service, reliability, speed of fulfillment, ease of use and ability to adapt to changing conditions. For our services segment and third-party sellers channel, additional competitive factors include the quality of our services and tools, and speed of performance for our services. As the online-commerce market segments continue to grow, other companies may also enter into business combinations or alliances that strengthen their competitive positions.

Intellectual Property

We regard our trademarks, service marks, copyrights, patents, trade dress, trade secrets, proprietary technology and similar intellectual property as critical to our success, and we rely on trademark, copyright and patent law, trade-secret protection and confidentiality and/or license agreements with our employees, customers, partners and others to protect our proprietary rights. We have been issued a number of trademarks, service marks, patents and copyrights by U.S. and foreign governmental authorities. We also have applied for the registration of other trademarks, service marks and copyrights in the U.S. and internationally, and we have filed U.S. and international patent applications covering certain of our proprietary technology. We have licensed in the past, and

expect that we may license in the future, certain of our proprietary rights, such as trademarks, patents, technologies or copyrighted materials, to third parties.

Employees

As of December 31, 2001, we employed approximately 7,800 full-time and part-time employees. We also employ independent contractors and temporary personnel on a seasonal basis. None of our employees are represented by a labor union and we consider our employee relations to be

good. Competition for qualified personnel in our industry is intense, particularly for software-development and other technical staff. We believe that our future success will depend in part on our continued ability to attract, hire and retain qualified personnel.

Additional Factors That May Affect Future Results

The following risk factors and other information included in this Annual Report should be carefully considered. The risks and uncertainties described below are not the only ones we face. Additional risks and uncertainties not presently known to us or that we currently deem immaterial also may impair our business operations. If any of the following risks occur, our business, financial condition, operating results and cash flows could be materially adversely affected.

We Have an Accumulated Deficit and May Incur Additional Losses

We have incurred significant losses since we began doing business. As of December 31, 2001, we had an accumulated deficit of $2.86 billion and our stockholders equity was a deficit of $1.44 billion. We have incurred substantial operating losses since our inception and, notwithstanding our recent performance in the fourth quarter of 2001, we may continue to incur such losses for the foreseeable future.

We Have Significant Indebtedness

As of December 31, 2001, we had total long-term indebtedness under our 10% Senior Discount Notes due 2008 (the Senior Discount Notes), convertible notes, capitalized-lease obligations and other asset financings of $2.16 billion. We make annual or semi-annual interest payments on the indebtedness under our two tranches of convertible notes, which are due in 2009 and 2010, respectively. Beginning in November 2003, we will begin to make semi-annual interest payments on the indebtedness under our Senior Discount Notes. We may incur substantial additional debt in the future. Our indebtedness could limit our ability to obtain necessary additional financing for working capital, capital expenditures, debt service requirements or other purposes in the future; plan for, or react to, changes in technology and in our business and competition; and react in the event of an economic downturn.

We may not be able to meet our debt service obligations. If we are unable to generate sufficient cash flow or obtain funds for required payments, or if we fail to comply with covenants in our indebtedness, we will be in default.

We Face Intense Competition

The e-commerce market segments in which we compete are relatively new, rapidly evolving and intensely competitive. In addition, the market segments in which we participate are intensely competitive and we have many competitors in different industries, including the Internet and retail industries.

Many of our current and potential competitors have longer operating histories, larger customer bases, greater brand recognition and significantly greater financial, marketing and other resources than we have. They may be able to secure merchandise from vendors on more favorable terms and may be able to adopt more aggressive pricing policies. Competitors in both the retail and e-commerce services industries also may be able to devote more resources to technology development and marketing than us.

Other companies in the retail and e-commerce service industries may enter into business combinations or alliances that strengthen their competitive positions. We also expect that competition in the e-commerce channel will intensify. As various Internet market segments obtain large, loyal customer bases, participants in those segments may expand into the market segments in which we operate. In addition, new and expanded Web technologies may further intensify the competitive nature of online retail. The nature of the Internet as an electronic marketplace facilitates competitive entry and comparison shopping and renders it inherently more competitive than conventional retailing formats. This increased competition may reduce our sales and/or operating profits.

Our Business Could Suffer if We Are Unsuccessful in Making and Integrating Strategic Alliances

We may enter into strategic alliances with other companies through commercial agreements, joint ventures, investments or business combinations. We have entered into third-party services agreements to provide services related to e-commerce to companies like Toysrus.com, Borders Group, America Online, Circuit City Stores, and Target, and we plan to enter into similar agreements in the future. Under such agreements, we may perform services such as offering consumer products sold by us through Syndicated Stores; allowing third parties to utilize our technology services such as search, browse and personalization; permitting third parties to offer products or services through our Web site; and powering third-party Web sites, providing fulfillment services, or both. These arrangements are complex and initially require substantial personnel and resource commitments by us, which may constrain the number of such agreements we are able to enter into and may affect our ability to deliver services under the relevant agreements. If we fail to implement, maintain and develop successfully the various components of such arrangements, which may include fulfillment, customer service, inventory management, tax collection, and third party licensing of software, hardware and content, our strategic alliance initiatives may not be viable. The amount of compensation we receive under certain of these agreements is dependent on the volume of sales that the other company makes. Therefore if the third party Web site or product or services

offering is not successful, we may not receive all of the compensation we are otherwise due under the terms of the agreement. Moreover, we may not be able to succeed in our plans to enter into additional strategic alliances on favorable terms.

In addition, our present and future third-party services agreements, other commercial agreements, joint ventures, investments and business combinations create risks such as:

- disruption of our ongoing business, including loss of management focus on existing businesses;
- impairment of relationships with existing employees, customers and companies with which we have formed strategic alliances;
- difficulty assimilating the operations, technology and personnel of combined companies;
- problems retaining key technical and managerial personnel;
- additional operating losses and expenses of acquired businesses; and
- fluctuations in value and losses that may arise from our equity investments.

The Seasonality of Our Business Places Increased Strain on Our Business

We expect a disproportionate amount of our net sales to be realized during the fourth quarter of our fiscal year. If we do not stock popular products in sufficient amounts and fail to meet customer demand, it could significantly affect our revenue and our future growth. If we overstock products, we may be required to take significant inventory markdowns or write-offs, which could reduce gross profits. A failure to optimize inventory in our fulfillment network will harm our shipping margins by requiring us to make partial shipments from one or more locations. In addition, we may experience a decline in our shipping margins due to complimentary upgrades, split-shipments and additional long-zone shipments necessary to ensure timely delivery especially for the holiday season. If too many customers access our Web sites within a short period of time due to increased holiday or other demand, we may experience system interruptions that make our Web sites unavailable or

prevent us from efficiently fulfilling orders, which may reduce the volume of goods we sell and the attractiveness of our products and services. In addition, we may be unable to adequately staff our fulfillment centers during these peak periods, and we, along with our customer service outsourcers, may be unable to adequately staff customer service centers.

We generally have payment terms with our vendors that extend beyond the amount of time necessary to collect proceeds from our customers. As a result of holiday sales, at December 31 of each year our cash, cash equivalents and marketable securities balance reaches its highest level (other than as a result of cash flows provided by investing and financing activities). This operating cycle results in a corresponding increase in accounts payable. Our accounts payable balance will decline during the first three months following year-end and will result in a decline in the amount of cash, cash equivalents and marketable securities on hand.

We May Experience Significant Fluctuations in Our Operating Results and Rate of Growth

Due to our limited operating history, our evolving business model and the unpredictability of our industry, we may not be able to accurately forecast our rate of growth. We base our current and future expense levels and our investment plans on estimates of future net sales and rate of growth. Our expenses and investments are to a large extent fixed. We may not be able to adjust our spending quickly if our net sales fall short of our expectations.

Our revenue and operating profit growth depends on the continued growth of online demand for the products offered by us or our third party sellers, and our business is affected by general economic and business conditions throughout the world. A softening of demand, whether caused by changes in consumer preferences or a weakening of the U.S. or global economies, may result in decreased revenue or growth. Recent terrorist attacks upon the U.S. have added economic and consumer uncertainty that could adversely affect our revenue or growth. Security concerns could create delays in and increase the cost of product shipments to and from us, which may decrease demand. Revenue growth may not be sustainable and our company-wide percentage growth rate may decrease in the future.

Our net sales and operating results will also fluctuate for many other reasons, including:

- our ability to retain and increase sales to existing customers, attract new customers and satisfy our customers demands;
- our ability to expand our network of third party sellers;
- foreign currency exchange rate fluctuations;

our ability to acquire merchandise, manage our inventory and fulfill orders;

the introduction by our competitors of Web sites, products or services;

changes in usage of the Internet and online services and consumer acceptance of the Internet and e-commerce;

timing and costs of upgrades and developments in our systems and infrastructure;

the effects of strategic alliances, acquisitions and other business combinations, and our ability to successfully integrate them into our business;

technical difficulties, system downtime or Internet brownouts;

variations in the mix of products and services we sell;

variations in our level of merchandise and vendor returns;

disruptions in service by shipping carriers; and

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the extent to which we offer free shipping promotions.

Finally, both seasonal fluctuations in Internet usage and traditional retail seasonality are likely to affect our business. Internet usage generally slows during the summer months, and sales in almost all of our product groups, particularly toys and electronics, usually increase significantly in the fourth calendar quarter of each year.

We Have Foreign Currency Exchange Rate Risk

We may be adversely affected by foreign currency exchange rate risk. Our 6.875% Convertible Subordinated Notes due 2010 (6.875% PEACS) are denominated in Euros, not U.S. dollars, and the exchange ratio between the Euro and the U.S. dollar is not fixed by the indenture governing the 6.875% PEACS. When we periodically remeasure the principal of the 6.875% PEACS fluctuations in the Euro/U.S. dollar exchange ratio, we will record non-cash gains or losses in Other gains (losses), net on our statements of operations. Furthermore, we have invested some of the proceeds from the 6.875% PEACS in Euro-denominated cash equivalents and marketable securities. Accordingly, as the U.S. dollar strengthens compared to the Euro, cash equivalents and marketable securities balances, when translated, may be materially less than expected and vice versa.

In addition, the results of operations of our internationally-focused Web sites are exposed to foreign currency exchange rate fluctuations as the financial results of the applicable subsidiaries are translated from the local currency into U.S. dollars upon consolidation. As exchange rates vary, net sales and other operating results, when translated, may differ materially from expectations.

Our Past and Planned Future Growth Will Place a Significant Strain on our Management, Operational and Financial Resources

We have rapidly and significantly expanded our operations and will endeavor to expand further to pursue growth of our product and service offerings and customer base. Such growth will continue to place a significant strain on our management, operational and financial resources. We also need to train and manage our employee base. Our current and planned personnel, systems, procedures and controls may not be adequate to support and effectively manage our future operations. We may not be able to hire, train, retain, motivate and manage required personnel, which may limit our growth.

In addition, we do not expect to benefit in our newer market segments from the first-to-market advantage that we experienced in the online book channel. Our gross profits in our newer business activities may be lower than in our older business activities. In addition, we may have limited or no experience in new product and service activities and our customers may not favorably receive our new businesses. In addition, to the extent we pursue strategic alliances to facilitate new product or service activities, the alliances may not be successful. If any of this were to occur, it could damage our reputation and negatively affect revenue growth.

The Loss of Key Senior Management Personnel Could Negatively Affect Our Business

We depend on the continued services and performance of our senior management and other key personnel, particularly Jeffrey P. Bezos, our President, Chief Executive Officer and Chairman of the Board. We do not have key person life insurance policies. The loss of any of our executive officers or other key employees could harm our business.

System Interruption and the Lack of Integration and Redundancy in Our Systems May Affect Our Sales

Customer access to our Web sites directly affects the volume of goods we sell and thus affects our net sales. We experience occasional system interruptions that make our Web sites unavailable or prevent us from efficiently fulfilling orders, which may reduce our net sales and the attractiveness of our products and services. To prevent system interruptions, we continually need to add additional software and hardware, upgrade our

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systems and network infrastructure to accommodate both increased traffic on our Web sites and increased sales volume, and integrate our systems.

Our computer and communications systems and operations could be damaged or interrupted by fire, flood, power loss, telecommunications failure, break-ins, earthquakes, acts of war or terrorism and similar events. We do not have backup systems or a formal disaster recovery plan, and we may have inadequate insurance coverage or insurance limits to compensate us for losses from a major interruption. Computer viruses, physical or electronic break-ins and similar disruptions could cause system interruptions, delays and loss of critical data, and could prevent us from providing services and accepting and fulfilling customer orders. If this were to occur, it could damage our reputation and be expensive to remedy.

We May Not Be Successful in Our Efforts to Expand into International Market Segments

We plan, over time, to continue to expand our reach in international market segments. We have relatively little experience in purchasing, marketing and distributing products or services for these market segments and may not benefit from any first-to-market advantages. It is costly to establish international facilities and operations, promote our brand internationally, and develop localized Web sites and stores and other systems. We may not succeed in these efforts. Our net sales from international market segments may not offset the expense of establishing and maintaining the related operations and, therefore, these operations may never be profitable.

Our international sales and related operations are subject to a number of risks inherent in selling abroad, including, but not limited to, risks with respect to:

- currency exchange rate fluctuations,
- local economic and political conditions,
- restrictive governmental actions (such as trade protection measures, including export duties and quotas and custom duties and tariffs),
- import or export licensing requirements,
- limitations on the repatriation of funds,
- difficulty in obtaining distribution and support,
- nationalization,
- longer receivable cycles,
- consumer protection laws and restrictions on pricing or discounts,
- lower level of adoption or use of the Internet and other technologies vital to our business, and the lack of appropriate infrastructure to support widespread Internet usage,
- lower level of credit card usage and increased payment risk,
- difficulty in developing employees and simultaneously managing a larger number of unique foreign operations as a result of distance, language and cultural differences,
- laws and policies of the U.S. affecting trade, foreign investment and loans, and
- tax and other laws.

As the international e-commerce channel continues to grow, competition will likely intensify. Local companies may have a substantial competitive advantage because of their greater understanding of, and focus on, the local customer, as well as their more established local brand name recognition. In addition, governments in foreign jurisdictions may regulate e-commerce or other online services in such areas as content, privacy, network security, copyright, encryption, taxation or distribution. We may not be able to hire, train, retain, motivate and manage required personnel, which may limit our growth in international market segments.

Our Strategic Alliances Subject Us to a Number of Risks

Beginning in 1999, we offered services to other e-commerce companies including permitting third parties to offer products or services on our Web site, and promotional services such as advertising placements and customer referrals. We may enter into similar transactions in the future. Beginning with our strategic alliance with Toysrus.com in 2000, we began expanding our range of services. We now offer a variety of services to third parties, including offering consumer products sold by us through Syndicated Stores; allowing third parties to utilize our technology services such as search, browse and personalization; and powering third-party Web-sites, providing fulfillment services, or both. In exchange for the services we provide under these agreements, we receive cash and/or equity securities of these companies (additional benefits may include Web site traffic). The amount of compensation we receive under certain of these agreements is dependent on the volume of sales made by the other company. In some cases, such as our agreement with drugstore.com, we have also made separate investments in the other company by making a cash payment in exchange for equity securities of that company. As part of this program, we may in the future make additional investments in companies with which we have already formed strategic alliances or companies with which we form new strategic alliances or similar arrangements. To the extent we have received equity securities as compensation, fluctuations in the value of such securities will affect our ultimate realization of amounts we have received as compensation for services.

We hold several investments in third parties, primarily investments in companies with which we have formed strategic alliances, that are accounted for using the equity method. Under the equity method, we are required to record our ownership percentage of the income or loss of these companies as income or loss for us. We record these amounts generally one month in arrears for private companies and three months in arrears for public companies. The losses we are required to record under the equity method with respect to a particular investment are limited to the carrying value of that investment. As of December 31, 2001, the carrying amount of several of our equity-method investees has been reduced to zero. The only remaining investees with carrying amounts are privately-held companies. The companies in which we have equity method investments are engaged in the Internet and e-commerce industries, are likely to experience large losses for the foreseeable future and may or may not be ultimately successful. Accordingly, we expect to record additional equity method losses in the future. Our investments in equity securities that are not accounted for under the equity method are included in Marketable securities and Other equity investments on our balance sheets.

We regularly review all of our investments in public and private companies for other-than-temporary declines in fair value. When we determine that the decline in fair value of an investment below our accounting basis is other-than-temporary, we reduce the carrying value of the securities we hold and record a loss in the amount of any such decline. During 2001, we determined that the declines in value of several of these investments were other-than-temporary, and we recognized losses totaling $44 million to record these investments at their then current fair value. Several of these companies have declared bankruptcy or liquidated.

We had net unrealized gains of $1 million on available-for-sale equity securities included in accumulated other comprehensive loss as of December 31, 2001, and have recorded equity-method losses of $30 million for the year ended December 31, 2001. In recent quarters, companies in the Internet and e-commerce industries have experienced significant difficulties, including difficulties in raising capital to fund expansion or to continue operations. We may conclude in future quarters that the fair values of other of these investments have experienced an other-than-temporary decline. As of December 31, 2001, our recorded basis in equity securities was $41 million, including $13 million classified as Marketable securities, $10 million classified as Investments in equity-method investees, and $18 million classified as Other equity investments. In addition, if companies with which we have formed strategic alliances experience such difficulties, we may not receive or fully realize the consideration owed to us and the value of our investment may become worthless. As our strategic alliances and similar agreements expire or otherwise terminate, we may be unable to renew or replace these agreements on terms that are as favorable to us, or at all.

During 2000 and 2001, we amended several of our agreements with certain of the companies with which we have formed strategic alliances that reduced future cash proceeds to be received by us, shortened the term of our

commercial agreements, or both. We may, in the future, enter into further amendments of our commercial agreements. Although these amendments did not affect the amount of unearned revenue previously recorded by us, the timing of revenue recognition of these recorded unearned amounts has been changed to correspond with the terms of the amended agreements. To the extent we believe any such amendments cause or may cause the compensation to be received under an agreement to no longer be fixed or determinable, we limit our revenue recognition to amounts received, excluding any future amounts not deemed fixed or determinable. As future amounts are subsequently received, such amounts are incorporated into our revenue recognition over the remaining term of the agreement.

We Face Significant Inventory Risk Arising Out of Changes in Consumer Demand and Product Cycles

We are exposed to significant inventory risks as a result of seasonality, new product launches, rapid changes in product cycles and changes in consumer tastes with respect to our products. In order to be successful, we must accurately predict these trends and avoid overstocking or under-stocking products. Demand for products, however, can change significantly between the time inventory is ordered and the date of sale. In addition, when we begin selling a new product, it is particularly difficult to forecast product demand accurately. A failure to optimize inventory within our fulfillment network will harm our shipping margins by requiring us to make split shipments from one or more locations, complimentary upgrades, and additional long-zone shipments necessary to ensure timely delivery. As a result of our agreements with Toysrus.com, Babiesrus.com, and Target, these parties will identify, buy, manage and bear the financial risk of inventory obsolescence for their corresponding stores and merchandise. As a result, if any of these parties fail to forecast product demand or optimize inventory, we would receive reduced service fees under the agreements and our business and reputation could be harmed.

The acquisition of certain types of inventory, or inventory from certain sources, may require significant lead-time and prepayment, and such inventory may not be returnable. We carry a broad selection and significant inventory levels of certain products, such as consumer electronics, and we may be unable to sell products in sufficient quantities or during the relevant selling seasons.

Our ability to receive inbound inventory efficiently or ship completed orders to customers may be negatively effected by inclement weather, fire, flood, power loss, earthquakes, acts of war or terrorism or acts of God.

Any one of the factors set forth above may require us to mark down or write off inventory, which will adversely affect our operating results.

If We Do Not Successfully Optimize and Operate Our Fulfillment Centers, Our Business Could Be Harmed

If we do not successfully operate our fulfillment centers, it could significantly limit our ability to meet customer demand. Most of our fulfillment centers are highly automated, and we have had limited experience with automated fulfillment centers. Because it is difficult to predict sales increases, we may not manage our facilities in an optimal way, which may result in excess inventory, warehousing, fulfillment and distribution capacity. In January 2001, we closed our fulfillment center in McDonough, Georgia and decided to operate the Seattle, Washington fulfillment center on a seasonal basis, if necessary. Under some of our strategic alliances, we maintain the inventory of other companies in our fulfillment centers, thereby increasing the complexity of tracking inventory in and operating our fulfillment centers. Our failure to properly handle such inventory would result in unexpected costs and other harm to our business and reputation.

We May Not Be Able to Adequately Protect Our Intellectual Property Rights or May Be Accused of Infringing Intellectual Property Rights of Third Parties

We regard our trademarks, service marks, copyrights, patents, trade dress, trade secrets, proprietary technology and similar intellectual property as critical to our success, and we rely on trademark, copyright and

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patent law, trade secret protection and confidentiality and/or license agreements with our employees, customers, partners and others to protect our proprietary rights. Effective trademark, service mark, copyright, patent and trade secret protection may not be available in every country in which our products and services are made available online. We also may not be able to acquire or maintain appropriate domain names in all countries in which we do business. Furthermore, regulations governing domain names may not protect our trademarks and similar proprietary rights. We may be unable to prevent third parties from acquiring domain names that are similar to, infringe upon or diminish the value of our trademarks and other proprietary rights. Policing unauthorized use of our proprietary rights is inherently difficult, and we may not be able to determine the existence or extent of any such unauthorized use. The protection of our intellectual property may require the expenditure of significant financial and managerial resources. Moreover, we cannot be certain that the steps we take to protect our intellectual property will adequately protect our rights or that others will not independently develop or otherwise acquire equivalent or superior technology or other intellectual property rights.

Third parties that license our proprietary rights may take actions that diminish the value of our proprietary rights or reputation. In addition, the steps we take to protect our proprietary rights may not be adequate and third parties may infringe or misappropriate our copyrights, trademarks, trade dress, patents and similar proprietary rights. Other parties may claim that we infringed their proprietary rights. We have been subject to, and expect to continue to be subject to, claims and legal proceedings regarding alleged infringement by us of the patents, trademarks and other intellectual property rights of third parties. Such claims, whether or not meritorious, may result in the expenditure of significant financial and managerial resources, injunctions against us or the imposition of damages that we must pay. We may need to obtain licenses from third parties who allege that we have infringed their rights, but such licenses may not be available on terms acceptable to us, or at all. In addition, we may not be able to obtain or utilize on terms which are favorable to us, or at all, licenses or other rights with respect to intellectual property we do not own in providing e-commerce services to third party sellers or other companies under strategic alliance agreements.

We Have a Limited Operating History and Our Stock Price Is Highly Volatile

We have a relatively short operating history and, as an e-commerce company, we have a rapidly evolving and unpredictable business model. The trading price of our common stock fluctuates significantly. Trading prices of our common stock may fluctuate in response to a number of events and factors, such as:

- general economic conditions,
- changes in interest rates,
- conditions or trends in the Internet and the e-commerce industry,
- fluctuations in the stock market in general and market prices for Internet-related companies in particular,
- quarterly variations in operating results,
- new products, services, innovations and strategic developments by our competitors or us, or business combinations and investments by our competitors or us,
- changes in financial estimates by us or securities analysts and recommendations by securities analysts,
- changes in Internet regulation,
- changes in capital structure, including issuance of additional debt or equity to the public,
- additions or departures of key personnel,
- corporate restructurings, including layoffs or closures of facilities,
- changes in the valuation methodology of, or performance by, other e-commerce companies, and
- news and securities analyst reports and speculation relating to new alliances, general business or Internet trends or our existing or future products or services.

Any of these events may cause our stock price to rise or fall, and may adversely affect our business and financing opportunities.

Future volatility in our stock price could force us to increase our cash compensation to employees or grant larger stock option awards than we have historically, which could hurt our operating results, or reduce the percentage ownership of our existing stockholders, or both. In the first quarter of 2001, we offered a limited non-compulsory exchange of employee stock options. This option exchange offer results in variable accounting treatment for stock options representing, at December 31, 2001, approximately 12 million shares of our common stock. Variable accounting treatment will result in unpredictable stock-based compensation dependent on fluctuations in quoted prices for our common stock.

Government Regulation of the Internet and E-commerce Is Evolving and Unfavorable Changes Could Harm our Business

We are subject to general business regulations and laws, as well as regulations and laws specifically governing the Internet and e-commerce. Such existing and future laws and regulations may impede the growth of the Internet or other online services. These regulations may cover taxation, user privacy, pricing, content, copyrights, distribution, electronic contracts, consumer protection, and characteristics and quality of products and services. It is not clear how existing laws governing issues such as property ownership, sales and other taxes, libel and personal privacy apply to the Internet and e-commerce. Unfavorable resolution of these issues may harm our business. In addition, many jurisdictions currently regulate auctions and auctioneers and may regulate online auction services. Jurisdictions may also regulate consumer-to-consumer fixed price online markets, like zShops. This could, in turn, diminish the demand for our products and services and increase our cost of doing business.

We May Be Subject to Liability for Past Sales and Our Future Sales May Decrease

In accordance with current industry practice, we do not collect sales taxes or other taxes with respect to shipments of most of our goods into states other than Washington and North Dakota. Under our agreements with Babiesrus.com, Target and Circuit City, the other company is the seller of record of the applicable merchandise and we are obligated to collect sales tax in most states in accordance with that company s instructions. We may enter into additional strategic alliances requiring similar tax collection obligations. We collect Value Added Tax, or VAT, for products that are ordered on *www.amazon.co.uk, www.amazon.de* and *www.amazon.fr* and that are shipped into European Union member

countries. We also collect Japanese consumption tax for products that are ordered on *www.amazon.co.jp* and that are shipped into Japan. Our fulfillment center and customer service center networks, and any future expansion of those networks, along with other aspects of our evolving business, may result in additional sales and other tax obligations. One or more states or foreign countries may seek to impose sales or other tax collection obligations on out-of-jurisdiction companies which engage in e-commerce. A successful assertion by one or more states or foreign countries that we should collect sales or other taxes on the sale of merchandise could result in substantial tax liabilities for past sales, decrease our ability to compete with traditional retailers and otherwise harm our business.

Currently, decisions of the U.S. Supreme Court restrict the imposition of obligations to collect state and local sales and use taxes with respect to sales made over the Internet. However, a number of states, as well as the U.S. Congress, have been considering various initiatives that could limit or supersede the Supreme Court s position regarding sales and use taxes on Internet sales. If any of these initiatives addressed the Supreme Court s constitutional concerns and resulted in a reversal of its current position, we could be required to collect sales and use taxes in states other than Washington and North Dakota. The imposition by state and local governments of various taxes upon Internet commerce could create administrative burdens for us and could decrease our future sales.

Various countries are currently evaluating their VAT positions on e-commerce transactions. Recently, for example, the Council of Economic and Finance Ministers of the European Union proposed a directive requiring

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that businesses in non-EU countries selling digital products and services to EU resident consumers collect and remit VAT in the country of the consumer s residence. If this directive is ratified by the EU Council of Ministers, it would likely become effective on January 1, 2003. It is possible that this and other future VAT legislation or changes to our business model may result in additional VAT collection obligations and administrative burdens.

We Source a Significant Portion of Our Inventory from a Few Vendors

Although we continue to increase our direct purchasing from manufacturers, we still source a significant amount of inventory from relatively few vendors. During 2001, approximately 21% of all inventory purchases were made from three major vendors, of which Ingram Book Group accounts for over 10%. We do not have long-term contracts or arrangements with most of our vendors to guarantee the availability of merchandise, particular payment terms or the extension of credit limits. Our current vendors may stop selling merchandise to us on acceptable terms. If that were the case, we may not be able to acquire merchandise from other suppliers in a timely and efficient manner and on acceptable terms.

We May Be Subject to Product Liability Claims if People or Property Are Harmed by the Products We Sell

Some of our products, such as toys, tools, hardware, computers, cell phones and kitchen and houseware products, may expose us to product liability claims relating to personal injury, death or property damage caused by such products, and may require us to take actions such as product recalls. Companies with which we have formed strategic alliances also may sell products that may indirectly increase our exposure to product liability claims. Although we maintain liability insurance, we cannot be certain that our coverage will be adequate for liabilities actually incurred or that insurance will continue to be available to us on economically reasonable terms, or at all. In addition, some of our vendor agreements with our suppliers do not indemnify us from product liability.

We Could Be Liable for Breaches of Security on Our Web Site and Fraudulent Activities of Users of Our Amazon Payments Program

A fundamental requirement for e-commerce is the secure transmission of confidential information over public networks. Although we have developed systems and processes that are designed to prevent fraudulent credit card transactions and other security breaches, failure to mitigate such fraud or breaches may adversely affect our financial results.

The law relating to the liability of providers of online payment services is currently unsettled. We guarantee payments made through Amazon Payments up to certain limits for both buyers and sellers, and we may be unable to prevent users of Amazon Payments from fraudulently receiving goods when payment may not be made to a seller or fraudulently collecting payments when goods may not be shipped to a buyer. Our liability risk will increase as a larger fraction of our sellers use Amazon Payments. Any costs we incur as a result of liability because of our guarantee of payments made through Amazon Payments or otherwise could harm our business. In addition, the functionality of Amazon Payments depends on certain third-party vendors delivering services. If these vendors are unable or unwilling to provide services, Amazon Payments will not be viable (and our businesses that use Amazon Payments may not be viable).

We May Not Be Able to Adapt Quickly Enough to Changing Customer Requirements and Industry Standards

Technology in the e-commerce industry changes rapidly. We may not be able to adapt quickly enough to changing customer requirements and preferences and industry standards. Competitors often introduce new products and services with new technologies. These changes and the emergence of new industry standards and practices could render our existing Web sites and proprietary technology obsolete.

The Internet as a Medium for Commerce Is Uncertain

Consumer use of the Internet as a medium for commerce is a recent phenomenon and is subject to a high level of uncertainty. While the number of Internet users has been rising, the Internet infrastructure may not expand fast enough to meet the increased levels of demand. If use of the Internet as a medium for commerce does not continue to grow or grows at a slower rate than we anticipate, our sales would be lower than expected and our business would be harmed.

We Could Be Liable for Unlawful or Fraudulent Activities by Users of Our Marketplace, Auctions and zShops Services

We may be unable to prevent users of our Amazon Marketplace, Auctions and zShops services from selling unlawful goods, or from selling goods in an unlawful manner. We may face civil or criminal liability for unlawful and fraudulent activities by our users under U.S. laws and/or the laws and regulations of other countries. Any costs we incur as a result of liability relating to the sale of unlawful goods, the unlawful sale of goods, the fraudulent receipt of goods or the fraudulent collection of payments could harm our business.

In running our Amazon Marketplace, Auctions and zShops services, we rely on sellers of goods to make accurate representations and provide reliable delivery, and on buyers to pay the agreed purchase price. We do not take responsibility for delivery of payment or goods and while we can suspend or terminate the accounts of users who fail to fulfill their delivery obligations to other users, we cannot require users to make payments or deliver goods. We do not compensate users who believe they have been defrauded by other users except through our guarantee program. Under the guarantee program, fraudulent activities by our users, such as the fraudulent receipt of goods and the fraudulent collection of payments, may create liability for us. In addition, we are aware that governmental agencies are currently investigating the conduct of online auctions and could require changes in the way we conduct this business.

Executive Officers and Directors

The following tables set forth certain information regarding our executive officers and Directors as of January 15, 2002:

Executive Officers

Name	Age	Position
Jeffrey P. Bezos	38	President, Chief Executive Officer and Chairman of the Board
Mark J. Britto	37	Senior Vice President, Worldwide Service Sales & Business Development
Richard L. Dalzell	44	Senior Vice President, Worldwide Architecture & Platform Software, and Chief Information Officer
Warren C. Jenson	45	Senior Vice President and Chief Financial Officer
Diego Piacentini	41	Senior Vice President, Worldwide Retail & Marketing
John D. Risher	36	Senior Vice President, Worldwide Application Software
Jeffrey A. Wilke	35	Senior Vice President, Worldwide Operations & Customer Service
L. Michelle Wilson	38	Senior Vice President, Human Resources, General Counsel and Secretary

Jeffrey P. Bezos. Mr. Bezos has been Chairman of the Board of Amazon.com since founding it in 1994 and Chief Executive Officer since May 1996. Mr. Bezos served as President from founding until June 1999 and again from October 2000 to the present. He served as Treasurer and Secretary from May 1996 to March 1997. From December 1990 to June 1994, Mr. Bezos was employed by D.E. Shaw & Co., a Wall Street investment firm, becoming Senior Vice President in 1992. From April 1988 to December 1990, Mr. Bezos was employed by

Bankers Trust Company, becoming Vice President in February 1990. Mr. Bezos received his B.S. in Electrical Engineering and Computer Science from Princeton University.

Mark J. Britto. Mr. Britto has served as Senior Vice President, Worldwide Service Sales and Business Development since November 2001. From February 2001 until November 2001, Mr. Britto was Senior Vice President, Cross-Site Merchandising. He served as Senior Vice President, Marketing and Cross-Site Merchandising from October 2000 until February 2001 and as Vice President, Strategic Alliances from August 1999 to October 2000. From June 1999 to August 1999, Mr. Britto served as Director of Business Development. Mr. Britto joined Amazon.com in June 1999 as part of the acquisition of Accept.com, which he co-founded in October 1998, and for which he served as a Vice President. From October 1994 through October 1998, Mr. Britto was Executive Vice President of Credit Policy at FirstUSA Bank, where he was responsible for their credit risk management practice. Prior to that, he served as Senior Vice President of Risk Management at NationsBank. Mr. Britto received an M.S. in Operations Research and a B.S. in Industrial Engineering and Operations Research from the University of California at Berkeley.

Richard L. Dalzell. Mr. Dalzell has served as Senior Vice President, Worldwide Architecture & Platform Software, and Chief Information Officer since November 2001. From October 2000 until November 2001, Mr. Dalzell was Senior Vice President and Chief Information Officer and prior to that, from joining Amazon.com in August 1997 until October 2000, he was Vice President and Chief Information Officer. From February 1990 to August 1997, Mr. Dalzell held several management positions within the Information Systems Division at Wal-Mart Stores, Inc., including Vice President of Information Systems from January 1994 to August 1997. From 1987 to 1990, Mr. Dalzell acted as the Business Development Manager for E-Systems, Inc. Prior to joining E-Systems, Inc. he served seven years in the United States Army as a teleprocessing officer. Mr. Dalzell received a B.S. in Engineering from the United States Military Academy, West Point.

Warren C. Jenson. Mr. Jenson joined Amazon.com in September 1999 as Senior Vice President and Chief Financial Officer. Before joining Amazon.com, Mr. Jenson was the Chief Financial Officer and Executive Vice President for Delta Air Lines from April 1998 to September 1999. From September 1992 to April 1998, Mr. Jenson served as Chief Financial Officer and Senior Vice President for the National Broadcasting Company (NBC), a subsidiary of General Electric, and participated in the development of MSNBC, the cable-Internet joint news venture between NBC and Microsoft. Mr. Jenson earned his Masters of Accountancy Business Taxation, and B.S. in Accounting from Brigham Young University.

Diego Piacentini. Mr. Piacentini has served as Senior Vice President, Retail & Marketing, since November 2001. From joining Amazon.com in February 2000 until November 2001, Mr. Piacentini was Senior Vice President and General Manager, International. From April 1997 until joining Amazon.com, Mr. Piacentini was Vice President and General Manager, Europe, of Apple Computer, Inc., with responsibility for Apple Computer s operations in Europe, the Middle East and Africa. From April 1996 to April 1997, Mr. Piacentini was European Sales Director of Apple Computer, Inc. From May 1995 until April 1996, Mr. Piacentini was General Manager of Apple Computer s Italy operations, and before that, from September 1994 to May 1995, Mr. Piacentini was Apple Computer s Sales Director for Italy. Mr. Piacentini joined Apple Computer in 1987. Prior to that time he held a financial management position at Fiatimpresit in Italy. Mr. Piacentini received a degree in Economics from Bocconi University in Milan, Italy.

John D. Risher. Mr. Risher has served as Senior Vice President, Worldwide Application Software, since November 2001. From February 2000 until November 2001, Mr. Risher was Senior Vice President, U.S. Stores. Mr. Risher joined Amazon.com in February 1997 as Vice President of Product Development, a position he held until November 1997, when he was named Senior Vice President of Product Development. From July 1991 to February 1997, Mr. Risher held a variety of marketing and project management positions at Microsoft Corporation, including Team Manager for Microsoft Access and Founder and Product Unit Manager for MS Investor, Microsoft s Web site for personal investment. Mr. Risher received his B.A. in Comparative Literature

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from Princeton University and his M.B.A. from Harvard Business School. As previously announced in November 2001, Mr. Risher has resigned from Amazon.com, effective March 2002.

Jeffrey A. Wilke. Mr. Wilke has served as Senior Vice President, Worldwide Operations and Customer Service, since January 2002. From October 2000 until January 2002, Mr. Wilke was Senior Vice President, Operations, and prior to that he had been Vice President and General Manager, Operations, since joining Amazon.com in September 1999. Previously, Mr. Wilke held a variety of positions at AlliedSignal from 1993 to 1999, including Vice President and General Manager of the Pharmaceutical Fine Chemicals unit from March 1999 to September 1999 and General Manager of the Carbon Materials and Technologies unit from August 1997 to February 1999. Prior to his employment at AlliedSignal, he was an information technology consultant with Andersen Consulting. He received a B.S.E. in chemical engineering from Princeton University and has an M.B.A. and Master of Science in chemical engineering from the Massachusetts Institute of Technology.

L. Michelle Wilson. Ms. Wilson has served as Senior Vice President, Human Resources, General Counsel and Secretary since March 2001. She served as Vice President, General Counsel and Secretary from July 1999 until March 2001. Ms. Wilson joined Amazon.com in March 1999 as Associate General Counsel, Mergers and Acquisitions and Finance. From January 1995 until March 1999, she was a partner in the law firm of Perkins Coie LLP. Ms. Wilson received a J.D. from the University of Chicago Law School and a B.A. in Finance from the University of Washington.

Board of Directors

Name	Age	Position
Jeffrey P. Bezos	38	President, Chief Executive Officer and Chairman of the Board
Tom A. Alberg	61	Managing Director of Madrona Venture Group
Scott D. Cook	49	Chairman of the Executive Committee of Intuit, Inc.
L. John Doerr	50	General Partner, Kleiner Perkins Caufield & Byers
Mark S. Hansen	47	Chairman and CEO of Fleming Companies, Inc.
Patricia Q. Stonesifer	45	President and Co-Chair of the Bill & Melinda Gates Foundation

Item 2. ***Properties***

We do not own any real estate. Our principal office facilities in the U.S. are located in several leased facilities in Seattle, Washington under leases that expire at various times through April 2011. Our office facilities in the U.S. comprise a total of 772,000 square feet, of which we currently occupy 539,000 square feet.

Our U.S. warehousing and fulfillment operations are housed in six fulfillment centers located in New Castle, Delaware; Fernley, Nevada; Coffeyville, Kansas; Lexington, Kentucky; Campbellsville, Kentucky; and Grand Forks, North Dakota. These fulfillment centers comprise a total of approximately 3.12 million square feet. The New Castle, Delaware fulfillment center lease expires in October 2002, and the remaining fulfillment center leases expire from 2008 through 2015. We also have several smaller facilities located near our fulfillment centers that we use for off-site storage and shipping; these are relatively short-term leases for space that fluctuates from a total of 340,000 to 710,000 square feet.

Our U.S. customer service operations utilize 76,000 square feet of office space and are located in Tacoma, Washington, Huntington, West Virginia and Grand Forks, North Dakota. The lease terms of these facilities expire in January 2006, April 2010 and November 2008, respectively.

Our data-center facilities are located in Washington state and Virginia with 120,000 combined square feet. These facilities are under leases that expire in February 2004, and September 2009, respectively.

We lease additional properties outside the U.S., including approximately 192,000 square feet of office space in Germany, France, Japan and the United Kingdom (of which we currently occupy 141,000 square feet);

833,000 combined square feet of available fulfillment center space in Germany, France and the United Kingdom; and 54,000 combined square feet of customer service space in Japan, the United Kingdom and Germany. The fulfillment centers in Germany, the United Kingdom, and France are located in Bad Hersfeld, Marston Gate, and Orleans, respectively, and the lease terms expire in December 2009, March 2025, and March 2009, respectively.

In January 2001, we closed our fulfillment center in McDonough, Georgia; closed our customer service center in Seattle, Washington; and decided to operate seasonally (as necessary) our fulfillment center in Seattle, Washington. The McDonough and Seattle fulfillment centers are still under lease and total 893,000 square feet.

We believe our properties are suitable and adequate for our present and anticipated near term needs.

Item 3. ***Legal Proceedings***

As previously disclosed in our Quarterly Report on Form 10-Q for the third quarter of 2000, we have received informal inquiries from the staff of the Securities and Exchange Commission Staff (the SEC) with respect to the accounting treatment and disclosures for some of our initial strategic alliances and have been cooperating with the SEC staff in responding to those inquiries. We reviewed our accounting treatment for the transactions with our independent auditors and the SEC staff, and we believe our accounting treatment and disclosures were appropriate. The SEC staff recently notified us that it believes the other party to one such transaction, Ashford.com, improperly reported the resolution of a business dispute with us, and that it is considering whether the Company, or any of its officers or employees may have facilitated Ashford.com s conduct. While there can be no assurance that the SEC will not pursue an enforcement action, we believe our actions at all times were proper and that this matter will not materially affect our results of operations or financial condition.

On April 12, 2001, we received a request from the SEC staff for the voluntary production of documents and information concerning, among other things, previously reported sales of our common stock by Jeffrey Bezos on February 2 and 5, 2001. We are cooperating with the SEC staff s continuing inquiry.

A number of purported class action complaints were filed by holders of our equity and debt securities against us, our directors and certain of our senior officers during 2001, in the United States District Court for the Western District of Washington, alleging violations of the Securities Act of 1933 (the 1933 Act) and/or the Securities Exchange Act of 1934 (the 1934 Act). On October 5, 2001, plaintiffs in the 1934 Act cases filed a consolidated amended complaint alleging that we, together with certain of our officers and directors and certain third-parties, made false or misleading statements during the period from October 29, 1998 through July 23, 2001 concerning our business, financial condition and results, inventories, future prospects, and strategic alliance transactions. The 1933 Act complaint alleges that the defendants made false or misleading statements in connection with our February 2000 offering of the 6.875% PEACS. The complaints seek recissionary and/or compensatory damages and injunctive relief against all defendants. We dispute the allegations of wrongdoing in these complaints and intend to vigorously defend ourselves in these matters.

Depending on the amount and the timing, an unfavorable resolution of some or all of these matters could materially affect our business, future results of operations, financial position or cash flows in a particular period.

From time to time, we are subject to other legal proceedings and claims in the ordinary course of business, including claims of alleged infringement of trademarks, copyrights, patents and other intellectual property rights. We currently are not aware of any such legal proceedings or claims that we believe will have, individually or in the aggregate, a material adverse effect on our business, financial condition or operating results.

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

No matters were submitted for a vote of our stockholders during the fourth quarter of the year ended December 31, 2001.

PART II

Item 5. ***Market for the Registrant s Common Stock and Related Stockholder Matters***

Market Information

Our common stock is traded on the Nasdaq National Market under the symbol AMZN. The following table sets forth the high and low sale prices for the common stock for the periods indicated, as reported by the Nasdaq National Market.

	High	Low
Year ended December 31, 2000		
First Quarter	$ 91.50	$ 58.44
Second Quarter	68.63	32.47
Third Quarter	49.63	27.88
Fourth Quarter	40.88	14.88
Year ended December 31, 2001		
First Quarter	$ 21.88	$ 10.00
Second Quarter	17.56	8.37
Third Quarter	16.98	5.97
Fourth Quarter	12.24	6.01

Holders

As of January 10, 2002, there were 4,013 stockholders of record of our common stock, although there is a much larger number of beneficial owners.

Dividends

We have never declared or paid cash dividends on our common stock. We intend to retain all future earnings to finance future growth and, therefore, do not anticipate paying any cash dividends in the foreseeable future. In addition, we are restricted from paying cash dividends under our Senior Discount Notes. See Management s Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources.

Recent Sales of Unregistered Securities

None.

Item 6. ***Selected Consolidated Financial Data***

The following selected consolidated financial data should be read in conjunction with the consolidated financial statements and the notes thereto and the information contained herein in Item 7 of Part II, Management s Discussion and Analysis of Financial Condition and Results of Operations. Historical results are not necessarily indicative of future results.

As of and for the Years Ended December 31,

	2001	2000	1999	1998 (1)	1997 (1)
	(in thousands, except per share data)				
Statements of Operations Data:					
Net sales	$ 3,122,433	$ 2,761,983	$ 1,639,839	$ 609,819	$ 147,787
Gross profit	798,558	655,777	290,645	133,664	28,818
Loss from operations	(412,257)	(863,880)	(605,755)	(109,055)	(32,595)
Interest income	29,103	40,821	45,451	14,053	1,901
Interest expense	(139,232)	(130,921)	(84,566)	(26,639)	(326)
Net loss	(567,277)	(1,411,273)	(719,968)	(124,546)	(31,020)
Basic and diluted net loss per share (2)	$ (1.56)	$ (4.02)	$ (2.20)	$ (0.42)	$ (0.12)
Shares used in computation of basic and diluted net loss per share (2)	364,211	350,873	326,753	296,344	260,682
Balance Sheet Data:					
Cash and cash equivalents	$ 540,282	$ 822,435	$ 133,309	$ 71,583	$ 110,119
Marketable securities	456,303	278,087	572,879	301,862	15,256
Total assets	1,637,547	2,135,169	2,465,850	648,460	149,844
Long-term debt	2,156,133	2,127,464	1,466,338	348,140	76,702
Stockholders Equity (Deficit)	(1,440,000)	(967,251)	266,278	138,745	28,591

(1) Reflects restatement for 1998 business acquisition accounted for under the pooling-of-interests method.

(2) For further discussion of loss per share, see Notes 1 and 10 of Notes to Consolidated Financial Statements.

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

Forward-Looking Statements

This Annual Report on Form 10-K includes forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. All statements other than statements of historical fact, including statements regarding industry prospects and future results of operations or financial position, made in this Annual Report on Form 10-K are forward looking. We use words such as anticipates, believes, expects, future, intends and similar expressions to identify forward-looking statements. Forward-looking statements reflect management s current expectations and are inherently uncertain. Our actual results may differ significantly from management s expectations. The following discussion includes forward-looking statements regarding expectations of future pro forma operating profitability and loss, net sales, cash flows from operations and free cash flows, all of which are inherently difficult to predict. Actual results could differ materially for a variety of reasons, including, among others, the rate of growth of the economy in general, the Internet and online commerce, customer spending patterns, the amount that we invest in new business opportunities and the timing of those investments, the mix of products sold to customers, the mix of net sales derived from products as compared with services, risks of inventory management, the degree to which we enter into, maintain and develop relationships with third party sellers and other strategic transactions, fluctuations in the value of securities and non-cash payments we receive in connection with such transactions, foreign currency exchange risks, seasonality, international growth and expansion, and risks of fulfillment throughput and productivity. These risks and uncertainties, as well as other risks and uncertainties that could cause our actual results to differ significantly from management s expectations, are described in greater detail in Item 1 of Part I, Business Additional Factors That May Affect Future Results, which, along with the following discussion, describes some, but not all, of the factors that could cause actual results to differ significantly from management s expectations.

Results of Operations

Net Sales

Net sales include the selling price of consumer products sold by us, less promotional gift certificates and sales returns; outbound shipping charges billed to our customers; commissions and other amounts earned from sales of new and used products on Amazon Marketplace, Auctions and zShops; amounts earned (fixed fees, sales commissions, per-unit activity fees, or some combination thereof) for sales of retail products through our Merchant@amazon.com Program, including our strategic alliances with Toysrus.com and Circuit City; the selling price of consumer products sold by us through our Syndicated Stores program, such as *www.borders.com*; amounts earned (fixed fees, sales commissions, per-unit activity fees, or some combination thereof) in connection with our Merchant Program, such as Target.com, which is scheduled to launch in the second half of 2002; commissions earned from third parties who utilize our technology services such as search, browse and personalization; and amounts earned for miscellaneous marketing and promotional agreements.

Net sales were $3.12 billion, $2.76 billion and $1.64 billion for 2001, 2000 and 1999, respectively, representing annual growth rates of 13% and 68% for 2001 and 2000, respectively. The reduced annual growth rate in our net sales is reflective of several factors, including the larger base comparison that results from our rapid growth in previous years, a shift in the source of our product sales towards new and used products sold through Amazon Marketplace, and declines in general economic conditions.

Net sales for our U.S. Books, Music and DVD/Video segment were $1.69 billion, $1.70 billion and $1.31 billion for 2001, 2000 and 1999, respectively. These results represent an annual decline in net sales for our U.S. Books, Music and DVD/Video segment of 1% for 2001, and an annual growth rate of 30% for 2000. This segment includes retail sales from *www.amazon.com* of books, music and DVDs/video products and for magazine subscriptions. This segment also includes commissions from sales of these products, new or used, through Amazon Marketplace and product revenues from stores offering these products through our Syndicated Stores Program, such as *www.borders.com*. Amazon Marketplace represented 12% of total orders in our U.S. Retail segments, primarily relating to our U.S. Books, Music and DVD/Video segment, during 2001. Amazon Marketplace orders were nominal in the prior year. The slowing annual growth rate reflects several factors including a shift in the source of our product sales towards new and used products sold through Amazon Marketplace, a continuing focus on balancing revenue growth with achieving operating profitability, and declines in general economic conditions.

Net sales for our U.S. Electronics, Tools and Kitchen segment were $547 million, $484 million and $151 million for 2001, 2000 and 1999, respectively. These results represent an annual growth rate of 13% for 2001. Since our U.S. Electronics, Tools and Kitchen segment began in the second half of 1999, annual growth rates for 2000 are not meaningful. This segment includes *www.amazon.com* retail sales of electronics, computers, camera and photo items, software, computer and video games, cell phones and service, tools and hardware, outdoor living items, kitchen and houseware products, toys and video games sold other than through our strategic alliance with Toysrus.com, Inc., as well as catalog sales of toys, tools and hardware. This segment also includes commissions from sales of these products, new or used, through Amazon Marketplace and commissions or other amounts earned from offerings of these products by third-party sellers through our Merchant@amazon.com Program, such as our strategic alliance with Circuit City. Excluding online sales of toys and video games which, since September 2000, have been sold at *www.amazon.com* primarily through our strategic alliance with Toysrus.com and reported in our Services segment, annual growth rates for our U.S. Electronics, Tools and Kitchen segment would have been 28% for 2001. Annual growth in net sales for our U.S. Electronics, Tools and Kitchen segment reflects increases in units sold by our electronics, kitchen and housewares, and outdoor living stores in comparison with 2000, offset by the effects of declines in average selling prices per unit, declines in general economic conditions, and the fact that most online sales of toys and video games are now sold through our strategic alliance with Toysrus.com and the corresponding revenue is therefore reported in our Services segment.

Net sales for our Services segment were $225 million, $198 million and $13 million for 2001, 2000 and 1999, respectively. These results represent an annual growth rate of 13% for 2001. Since we began offering services in late 1999, annual growth rates for 2000 are not meaningful. This segment consists of commissions, fees and other amounts earned from our business-to-business strategic alliances, including our Merchant Program and, to the extent product categories are not also offered by us through our online retail stores, our Merchant@amazon.com Program, as well as our strategic alliance with America Online, Inc. This segment also includes Auctions, zShops and Payments, and miscellaneous marketing and promotional agreements. The increase in net sales from our Services segment during 2001 was primarily associated with our Toysrus.com strategic alliance, which commenced September 2000, offset by the conclusion of certain of our initial strategic marketing relationships. Included in service revenues are equity-based service revenues of $27 million, $79 million and $7 million for 2001, 2000 and 1999, respectively. Equity-based service revenues result from private and public securities received by us and amortized into our results of operations over the period services are performed.

Net sales for our International segment were $661 million, $381 million and $168 million for 2001, 2000 and 1999, respectively. These results represent annual growth rates of 74% and 127% for 2001 and 2000, respectively. This segment includes all retail sales of our four internationally-focused Web sites: *www.amazon.co.uk*, *www.amazon.de*, *www.amazon.fr* and *www.amazon.co.jp*. These international sites share a common Amazon experience, but are localized in terms of language, products, customer service and fulfillment. This segment includes commissions and other amounts earned from offerings of these products by third party sellers through our Merchant@amazon.com Program, and product revenues from stores offering these products through our internationally-focused Syndicated Stores Program, such as *www.waterstones.co.uk*. The annual growth rate in 2001 reflects increases in units sold by our *www.amazon.de* and *www.amazon.co.uk* sites, as well as the launch of our *www.amazon.fr* and *www.amazon.co.jp* sites during the second half of 2000. The annual growth rate for our International segment during 2000 primarily relates to sales from our *www.amazon.co.uk, www.amazon.de* Web sites, and are reflective of the early stage of their operation with relatively smaller comparison sales bases. Sales to customers outside the United States, including export sales from *www.amazon.com* (which are reported in the corresponding U.S. segment), represented, as a percentage of consolidated net sales, approximately 29% and 22% for 2001 and 2000, respectively.

Shipping revenue, which consists of outbound shipping charges to our customers, across all segments was $357 million, $339 million and $239 million for 2001, 2000 and 1999, respectively. Shipping revenue generally corresponds with unit sales levels, offset by our periodic free and the reduced-shipping promotions. In January 2002, we introduced a new shipping option at *www.amazon.com*, offering free shipping for certain orders of $99 or more. We offer or may offer a similar shipping option for our internationally-focused Web sites. The effect of this shipping offer will reduce shipping revenue as a percentage of sales, and will cause our gross margins on retail sales to decline.

We expect net sales to be between $775 million and $825 million for the quarter ending March 31, 2002, an increase of between 11% and 18%, and net sales to increase 10% or more in 2002 compared to 2001. However, any such projections are subject to substantial uncertainty. See Item 1 of Part I, Business Additional Factors that May Affect Future Results.

Gross Profit

Gross profit is net sales less the cost of sales, which consists of the purchase price of consumer products sold by us, inbound and outbound shipping charges to us, packaging supplies, and certain costs associated with our service revenues. Costs associated with our service revenues classified as cost of services generally include fulfillment-related costs to ship products on behalf of third-party sellers, costs to provide customer service, credit card fees and other related costs.

We are currently considering prospectively changing our inventory costing method to the first-in first-out (FIFO) method of accounting which would, if applied, become effective January 1, 2002. We are currently determining the effect this change would have on our financial statements, whether this change would be significant, and whether it meets preferability requirements under generally accepted accounting principles. We believe the change would facilitate our record keeping process, and in turn, our ability to provide fulfillment services to third-party companies as part of our services offering, and would result in increased consistency with others in our industry. Although we have not yet completed our analysis of this potential change, based on our preliminary analysis, we do not anticipate the effect of such change, if applied, to have a significant cumulative effect on results of operations in the fiscal year of adoption, nor on amounts previously reported as inventory or Cost of sales as if the FIFO method had been applied in previous years.

Gross profit was $799 million, $656 million and $291 million for 2001, 2000 and 1999, respectively, representing increases of 22% and 126% for 2001 and 2000, respectively. Gross margin was 26%, 24% and 18% for 2001, 2000 and 1999, respectively. Increases in the absolute dollars of gross profit during each period corresponds with increases in units sold, improvements in inventory management, and improved product sourcing. Excluding the results of our Services segment, gross margin would have been 23%, 21% and 17%, respectively.

Gross profit for our U.S. Books, Music and DVD/video segment was $453 million, $417 million and $263 million for 2001, 2000 and 1999, respectively, which represents increases of 9% and 59% for 2001 and 2000, respectively. Gross margin was 27%, 25% and 20% for 2001, 2000 and 1999, respectively. Improvements in gross margins during 2001 correspond with improvements in inventory management, continued improvements in product sourcing and, to a lesser extent, the higher margin sales of new and used products sold through Amazon Marketplace, offset by higher customer discounts. Improvements in gross margin during 2000 in comparison to 1999 reflect improvements in inventory management and product sourcing, and lower customer discounts offered.

Gross profit for our U.S. Electronics, Tools and Kitchen segment was $78 million and $45 million for 2001 and 2000, respectively, representing an increase of 76% for 2001. This segment reported a gross loss of $20 million for 1999. Gross margin was 14% and 9% for 2001 and 2000, respectively, and negative 13% during 1999. Improvements in gross profit for each of the comparative periods corresponds with increases in net sales, improvements in product sourcing, the introduction of new product categories, and improvements in inventory management. Also, since most online sales of toys and video games, since September 2000, are sold through our strategic alliance with Toysrus.com, the corresponding gross profit is therefore reported in our Services segment.

Gross profit for our Services segment was $126 million, $116 million and $12 million for 2001, 2000 and 1999, respectively, which represents an increase of 9% for 2001. Since we began offering services in late 1999, annual growth rate for 2000 is not meaningful. Costs associated with our service revenues classified as cost of services generally include fulfillment-related costs to ship products on behalf of third-party sellers, costs to provide customer service, credit card fees and other related costs. Gross margin was 56%, 59% and 93% for 2001, 2000 and 1999, respectively. Gross profit from our Services segment largely corresponds with revenues from our business-to-business strategic alliances, which includes our Merchant Program and, to the extent product categories are not also offered by us through our online retail stores, the Merchant@amazon.com Program, as well as our strategic alliance with America Online, Inc. Gross profit for our Services segment also includes amounts earned through Auctions, zShops and Payments, and miscellaneous marketing and promotional agreements. The decline in gross margin from our Services segment for 2001 relates to service costs classified in cost of sales resulting from the shift in the mix of our strategic relationships towards alliances that incorporate a broader range of services, including fulfillment. Also contributing to the decline in Services gross margin was a reduction in high-margin marketing and promotional agreements. Included in service revenues are equity-based service revenues of $27 million, $79 million and $7 million for 2001, 2000 and 1999, respectively. Equity-based service revenues result from private and public securities received by us and amortized into our results of operations over the period services are performed.

Gross profit for our International segment was $141 million, $77 million and $36 million for 2001, 2000 and 1999, respectively, which represents increases of 82% and 118% for 2001 and 2000, respectively. Gross margin was 21%, 20% and 21% for 2001, 2000 and 1999,

respectively. The increase in our absolute gross profit dollars during 2001 and 2000 reflects increases in units sold by our *www.amazon.de* and *www.amazon.co.uk* sites in comparison with the same periods in the prior year, as well as the launch of our *www.amazon.fr* and *www.amazon.co.jp* sites during the second half of 2000. The increase in our absolute gross profit dollars during 1999 relates primarily to increases in units sold by our *www.amazon.de* and *www.amazon.co.uk* sites in comparison with the same periods in the prior year.

Shipping gross loss across all segments was $19 million and $1 million for 2001 and 2000, respectively, and shipping gross profit was $12 million for 1999. The gross loss in shipping in 2001 and 2000 was due, in part, to a higher revenue mix from our business units in countries that offer free shipping or product lines that involve low-margin shipping, as well as selective free-shipping promotions in the U.S. Shipping losses incurred from our internationally-focused Web sites, which are included in shipping results across all segments, were $14 million, $6 million and $4 million for 2001, 2000 and 1999, respectively. We continue to measure our shipping results relative to their effect on our overall financial results, with the viewpoint that shipping promotions are an effective promotional tool. In January 2002, we introduced a new shipping option at *www.amazon.com*, offering free shipping for certain orders of $99 or more. We offer or may offer a similar shipping option for our internationally-focused Web sites. The effect of this shipping offer will reduce shipping revenue as a percentage of sales, and will negatively affect gross margins on our retail sales.

Fulfillment

Fulfillment costs represent those costs incurred in operating and staffing our fulfillment and customer service centers, including costs attributable to receiving, inspecting and warehousing inventories; picking, packaging and preparing customers orders for shipment; credit card fees and bad debt costs; and responding to inquiries from customers. Fulfillment costs also include amounts paid to third-party co-sourcers who assist us in fulfillment and customer service operations. Certain fulfillment-related costs to ship products on behalf of third-party sellers, excluding those costs associated with Syndicated Stores, are classified as cost of sales rather than fulfillment. Fulfillment costs were $374 million, $415 million and $237 million for 2001, 2000 and 1999, respectively, representing 12%, 15% and 14% of net sales for the corresponding periods. Excluding net sales from our services segment, fulfillment costs represent 13%, 16% and 15% of net sales for 2001, 2000 and 1999, respectively. The improvement in fulfillment costs as a percentage of net sales during 2001 in comparison to 2000 results from improvements in productivity, the increase in units fulfilled helping to leverage our fixed-cost base, a decline in customer service contacts resulting from improvements in our customer self-service features available on our Web sites, improved balancing of inventory throughout our network that resulted in fewer split shipments, and our operational restructuring announced in January 2001. Our operational restructuring included the closure of our fulfillment center in McDonough, Georgia; the seasonal closure of our Seattle, Washington fulfillment center, which was not utilized during the 2001 holiday season; and the closure of our customer service centers in The Hague, Netherlands and Seattle, Washington.

Marketing

Marketing expenses consist of advertising, promotional and public relations expenditures, and payroll and related expenses for personnel engaged in marketing and selling activities. Marketing expenses, net of co-operative marketing reimbursements, were $138 million, $180 million and $176 million, representing 4%, 7% and 11% of net sales for 2001, 2000 and 1999, respectively. Declines in expense for marketing-related activities in comparison to prior years reflect management efforts to target advertising spending in channels considered most effective at driving incremental net sales (such as targeted on-line advertising through various Web portals and our Associates Program), an increase in co-operative marketing allowances during 2001, and the general decline in market costs for advertising-related promotions. In January 2002 we introduced a new shipping option at *www.amazon.com*, offering free shipping for certain orders of $99 or more. We offer or may offer a similar

shipping option for our internationally-focused Web sites. Although marketing expenses do not include our free and reduced shipping offers, we view such promotions as an effective marketing tool.

Technology and Content

Technology and content expenses consist principally of payroll and related expenses for development, editorial, systems and telecommunications operations personnel and consultants; systems and telecommunications infrastructure; and costs of acquired content, including freelance reviews. Technology and content expense was $241 million, $269 million and $160 million for 2001, 2000 and 1999, respectively, representing 8%, 10% and 10% of net sales for the corresponding periods, respectively. The decline in absolute dollars spent during 2001 in comparison to the prior year primarily reflect our migration to a technology platform that utilizes a less-costly technology infrastructure, as well as improved expense management and general price reductions in most expense categories, including data and telecommunication services, due to market overcapacity. The increase in absolute dollars spent during 2000 in comparison to 1999 primarily reflects past investments in our systems and telecommunications infrastructure to support the continual enhancements to our Web site, as well as costs associated with launching our *www.amazon.fr* and *www.amazon.co.jp* sites during 2000. We expect to continue to invest in technology and improvements in our Web sites during 2002, which may include, but is not limited to, offering additional Web site features and product categories to our customers and implementing additional strategic alliances, as well as potentially continuing our international expansion.

General and Administrative

General and administrative expenses consist of payroll and related expenses for executive, finance and administrative personnel, recruiting, professional fees and other general corporate expenses. General and administrative expenses were $90 million, $109 million and $70 million for 2001, 2000 and 1999, respectively, representing 3%, 4% and 4% of net sales for the corresponding periods, respectively. The decline in absolute dollars of general and administrative costs during 2001 in comparison with 2000 was primarily due to our operational restructuring plan announced in January 2001, which reduced the number of positions in corporate and administrative roles and consolidated our corporate office locations. The increase in general and administrative costs during 2000 in comparison to 1999 relates primarily to increases in personnel, facility-related costs associated with our corporate expansion, and professional fees associated with general corporate matters.

Stock-Based Compensation

Stock-based compensation includes stock-based charges resulting from variable accounting treatment of certain stock options, option-related deferred compensation recorded at our initial public offering, as well as certain other compensation and severance arrangements. Stock-based compensation also includes the portion of acquisition-related consideration conditioned on the continued tenure of key employees of certain acquired businesses, which must be classified as compensation expense rather than as a component of purchase price under accounting principles generally accepted in the U.S. Stock-based compensation was $5 million, $25 million and $31 million for 2001, 2000 and 1999, respectively. The declines in stock-based compensation during 2001 and 2000 in comparison to the prior respective years resulted from the full vesting and corresponding full recognition of deferred stock-based compensation relating to employees of certain acquired businesses.

The following table shows the amounts of stock-based compensation that would have been recorded under the following categories had stock-based compensation not been separately stated on the statements of operations.

	For the Years Ended December 31,		
	2001	**2000**	**1999**
		(in thousands)	
Fulfillment	$ 481	$ (1,606)	$ 188
Marketing	690	(858)	3,957
Technology and content	2,723	28,253	25,322
General and administrative	743	(992)	1,151
	$ 4,637	$ 24,797	$ 30,618

During the first quarter of 2001, we offered a limited non-compulsory exchange of employee stock options. The exchange resulted in the voluntary cancellation of employee stock options to purchase 31 million shares of common stock with varying exercise prices in exchange for 12 million employee stock options with an exercise price of $13.375. The option exchange offer resulted in variable accounting treatment for, at the time of the exchange, approximately 15 million stock options, which includes options granted under the exchange offer and 3 million options, with a weighted average exercise price of $52.41, that were subject to the exchange offer but were not exchanged. Variable accounting will continue until all options subject to variable accounting treatment are exercised, cancelled or expired. At December 31, 2001, approximately 12 million options remain under variable accounting treatment, which includes 11 million options granted under the exchange offer, which, if not previously exercised, will expire on September 30, 2003, and 1 million options, with a weighted average exercise price of $39.61, that were subject to the exchange offer but were not exchanged.

Variable accounting treatment will result in unpredictable and potentially significant charges or credits recorded to Stock-based compensation, dependent on fluctuations in quoted prices for our common stock. We have quantified the hypothetical effect on Stock-based compensation associated with increases in the quoted price of our common stock using a sensitivity analysis for our outstanding stock options subject to variable accounting at December 31, 2001. We have provided this information to provide additional insight into the potential volatility we may experience in the future in our results of operations to the extent that the quoted price for our common stock rises above $13.375. This sensitivity analysis is not a prediction of future performance of the quoted prices of our common stock. Using the following hypothetical increases in the market price of our common stock above $13.375, our hypothetical cumulative compensation expense at December 31, 2001 resulting from variable-accounting treatment would have been as follows:

Hypothetical Increase Over	Hypothetical Market Price	Hypothetical Cumulative

$13.375	per Share	Compensation Expense
		(in thousands)
5%	$14.04	$ 6,788
10%	$14.71	$ 12,578
15%	$15.38	$ 18,369
25%	$16.72	$ 29,950
50%	$20.06	$ 58,902

If at the end of any fiscal quarter the quoted price of our common stock is lower than the quoted price at the end of the previous fiscal quarter, or to the extent previously-recorded amounts relate to unvested portions of options that were cancelled, compensation expense associated with variable accounting will be recalculated using the cumulative expense method and may result, in certain circumstances, in a net benefit to our results of operations.

Amortization of Goodwill and Other Intangibles

Amortization of goodwill and other intangibles was $181 million, $322 million and $215 million for 2001, 2000 and 1999, respectively. During the fourth quarter of 2000, we recorded an impairment loss of $184 million on goodwill and other intangibles relating to certain of our 1999 acquisitions. This impairment loss reduced our recorded basis in goodwill and other intangibles and had the effect of reducing amortization expense during 2001. In July 2001, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 142, Goodwill and Other Intangible Assets, which requires use of a nonamortization approach to account for purchased goodwill and certain intangibles, effective January 1, 2002. Under this nonamortization approach, goodwill and certain intangibles will not be amortized into results of operations, but instead will be reviewed for impairment and written down and charged to results of operations only in the periods in which the recorded value of goodwill and certain intangibles is more than its fair value. We expect the adoption of this accounting standard will result in approximately $25 million of other intangible assets being subsumed into goodwill, and will have the effect of substantially reducing our amortization of goodwill and intangibles commencing January 1, 2002. Transitional impairments, if any, are not expected to be material; however, impairment reviews may result in future periodic write-downs.

Restructuring-Related and Other

Restructuring-related and other expenses were $182 million, $200 million and $8 million for 2001, 2000 and 1999, respectively. In the first quarter of 2001, we announced and began implementation of our operational restructuring plan to reduce operating costs, streamline our organizational structure, and consolidate certain of our fulfillment and customer service operations. This initiative involved the reduction of employee staff by approximately 1,300 positions in managerial, professional, clerical, technical and fulfillment roles; consolidation of our Seattle, Washington corporate office locations; closure of our McDonough, Georgia fulfillment center; seasonal operation of our Seattle, Washington fulfillment center (if necessary); closure of our customer service centers in Seattle, Washington and The Hague, Netherlands; and migration of a large portion of our technology infrastructure to a new operating platform, which entails ongoing lease obligations for technology infrastructure no longer being utilized. Each component of the restructuring plan has been substantially completed. As of December 31, 2001, 1,327 employees had been terminated, and actual termination benefits paid were $12 million.

Costs that relate to ongoing operations are not part of restructuring charges and are not included in Restructuring-related and other. In accordance with EITF Issue No. 96-9, Classification of Inventory Markdowns and Other Costs Associated with a Restructuring, all inventory adjustments that may result from the closure or seasonal operation of our fulfillment centers are classified in Cost of goods sold on the statements of operations. As of December 31, 2001, there have been no significant inventory write downs resulting from the restructuring, and none are anticipated.

For the year ended December 31, 2001, the charges associated with the restructuring were as follows (in thousands):

Asset impairments	$ 68,528
Continuing lease obligations	87,049
Termination benefits	14,970
Broker commissions, professional fees and other miscellaneous restructuring costs	11,038
	$ 181,585

Asset impairments primarily relate to the closure of the McDonough, Georgia fulfillment center, the write-off of leasehold improvements in vacated corporate office space, and the decline in the fair value of assets in the Seattle, Washington fulfillment center. For assets to be disposed of, we estimated the fair value based on expected salvage value less costs to sell. For assets held for continued use, the decline in fair value was measured

using discounted estimates of future cash flows. At December 31, 2001 the carrying amount of assets held for disposal was not significant.

Continuing lease obligations primarily relate to heavy equipment previously used in the McDonough, Georgia fulfillment center, vacated corporate office space, technology infrastructure no longer being utilized, and the unutilized portion of our back-up data center. We are actively seeking third parties to sub-lease abandoned equipment and facilities. Amounts expensed represent estimates of undiscounted future cash outflows, offset by anticipated third-party sub-leases. At December 31, 2001, we remain obligated under gross lease obligations of $121 million associated with our operational restructuring and we anticipate receiving sub-lease income of $68 million to offset these obligations, of which $17 million is to be received under non-cancelable subleases. Given the uncertainty of estimating future sub-lease rentals, actual results may differ from estimates which may result in significant additional expenses for us and corresponding net cash outflow above amounts expected.

Termination benefits are comprised of severance-related payments for all employees terminated in connection with the operational restructuring, as well as $2.5 million of our common stock contributed to a trust fund for the benefit of terminated employees. Termination benefits do not include any amounts for employment-related services prior to termination. Other restructuring costs include professional fees, decommissioning costs of vacated facilities, broker commissions and other miscellaneous expenses directly attributable to the restructuring.

At December 31, 2001, the accrued liability associated with the restructuring-related and other charges was $61 million and consisted of the following (in thousands):

	Balance at March 31, 2001	Subsequent Accruals, net	Non-Cash Settlements and Other Adjustments	Payments	Balance at December 31, 2001	Due Within 12 Months	Due After 12 Months
Lease obligations	$ 34,667	$ 52,738	$ (2,675)	$ (31,543)	$ 53,187	$ 35,578	$ 17,609
Termination benefits	8,445	113	(2,354)	(6,143)	61	61	
Broker commissions, professional fees and other miscellaneous restructuring costs	4,121	5,052	1,559	(2,542)	8,190	5,159	3,031
	$ 47,233	$ 57,903	$ (3,470)	$ (40,228)	$ 61,438	$ 40,798	$ 20,640

Cash payments resulting from our operational restructuring during 2001 were $49 million. We anticipate the restructuring charges will result in the following net cash outflows (in thousands):

	Leases	Termination Benefits	Other	Total
Year Ending December 31,				
2002	$ 35,578	$ 61	$ 5,159	$ 40,798
2003	5,476		3,031	8,507
2004	2,016			2,016
2005	1,983			1,983
2006	2,068			2,068
Thereafter	6,066			6,066
Total estimated cash outflows	$ 53,187	$ 61	$ 8,190	$ 61,438

During 2000, we identified certain levels of impairment corresponding with the business-unit goodwill and other intangibles initially recorded in connection with the following acquisitions: Alexa Internet, Back to Basics Toys, Inc., Livebid, Inc., and the catalog and Internet assets of Acme Electric Motor Co. (Tool Crib). Accordingly, we recorded an impairment loss of $184 million. Also during 2000, we recorded an impairment loss of $11 million relating to the decline in fair value, measured using discounted estimates of future cash flows, of

certain fixed assets. The fixed-asset impairment amount included $4 million, $3 million and $4 million of computers, equipment and software; leasehold improvements; and leased assets, respectively.

Other costs associated with our acquisition-related activities were $5 million and $8 million for 2000 and 1999, respectively. No such amounts were recorded during 2001.

Loss from Operations

Our loss from operations was $412 million, $864 million and $606 million for 2001, 2000 and 1999, respectively. The improvement in operating loss for 2001 in comparison with the prior period was primarily due to an increase in gross profit; a reduction in certain operating costs including fulfillment, marketing, technology and content, and general and administrative; and declines in charges such as amortization of goodwill and other intangibles.

Net Interest Expense and Other

Net interest expense and other, excluding Other gains (losses), net, was $112 million, $100 million and $37 million for 2001, 2000 and 1999, respectively. Interest income was $29 million, $41 million and $45 million for 2001, 2000 and 1999, respectively. Interest expense was $139 million, $131 million and $85 million for 2001, 2000 and 1999. Other income and expense, consisting primarily of realized gains and losses on sales of marketable securities, miscellaneous state and foreign taxes and certain realized foreign-currency related transactional gains and losses, was an expense of $2 million and $10 million for 2001 and 2000, respectively, and a gain of $2 million for 1999. Interest income relates primarily to interest earned on fixed income securities and correlates with the average balance of those investments and prevailing interest rates. The increase in interest expense during 2001 in comparison with 2000 is primarily related to our February 2000 issuance of the 6.875% PEACS. Other components of interest expense include our February 1999 issuance of $1.25 billion of 4.75% Convertible Subordinated Notes due 2009 (the 4.75% Convertible Subordinated Notes), and our May 1998 issuance of approximately $326 million gross proceeds of 10% Senior Discount Notes due 2008 (the Senior Discount Notes). At December 31, 2001, our total long-term indebtedness was $2.16 billion.

Other Gains (Losses), Net

Other gains (losses), net were recorded during 2001 and 2000, resulting in net costs of $2 million and $143 million, respectively. No comparable amounts were recorded during 1999. Other gains (losses), net consisted of the following:

	Years Ended December 31,	
	2001	2000
	(in thousands)	
Foreign-currency gains on 6.875% PEACS	$ 46,613	$
Losses on sales of Euro-denominated investments, net	(22,548)	
Other-than-temporary impairment losses, equity investments	(43,588)	(188,832)
Contract termination by third parties	22,400	6,033
Net gains from acquisition of investments by third parties	784	40,160
Warrant fair-value remeasurements and other	(5,802)	
	$ (2,141)	$ (142,639)

Effective January 1, 2001, currency gains and losses arising from the remeasurement of the 6.875% PEACS s principal from Euros to U.S. dollars each period are recorded to Other gains (losses), net on our statements of operations. Prior to January 1, 2001, 6.875% PEACS s principal of 615 million Euros was designated as a hedge of equivalent amount of Euro-denominated investments classified as available-for-sale; accordingly, currency gains and losses on the 6.875% PEACS were recorded to Accumulated other

comprehensive loss on our balance sheets as hedging offsets to currency gains and losses on the Euro-denominated investments. As the hedge does not qualify for hedge accounting under the provisions of SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities, commencing January 1, 2001, the foreign currency change resulting from the portion of the 6.875% PEACS previously hedging the available-for-sale securities is now being recorded on our statements of operations. For 2001, the remeasurement of the 6.875% PEACS resulted in a gain of $47 million consisting of a $10 million gain reclassified from Accumulated other comprehensive loss, and a $37 million gain attributable to remeasurement of the 6.875% PEACS during the period. We are unable to forecast or predict the loss or gain on our

Euro-denominated debt that will result from fluctuations in foreign exchange rates in future periods; any such amounts may have a significant effect on our future reported results.

During 2001 and 2000, we recorded impairment losses, which totaled $44 million and $189 million, respectively, relating to other-than-temporary declines in certain of our equity investments. These impairments were recorded to reflect the investments at fair value as of the date of impairment. During 2001, our other-than-temporary declines in fair value of investments were associated with our investments in Webvan Group, Inc, Sotheby s Holdings, Inc., WeddingChannel.com, Inc., Ashford.com, Inc., Audible, Inc., drugstore.com, inc., and Angel II Investors, L.P. During 2000, our other-than-temporary declines in fair value of investments were associated with Audible, NextCard, Inc., Webvan, Ashford.com, Greg Manning Auctions, Inc, and Sotheby s. At December 31, 2001 we have no further loss exposure relating to our investment in Webvan.

In February 2001, we terminated our commercial agreement with Kozmo.com and recorded a non-cash gain of $22 million, representing the amount of unearned revenue associated with the contract. Since services had not yet been performed under the contract, no amounts associated with this commercial agreement were recognized in Net sales during any period. Furthermore, during 1999, we made a cash investment of $60 million to acquire preferred stock of Kozmo.com and accounted for our investment under the equity method of accounting. Pursuant to the equity method of accounting, we recorded our share of Kozmo.com losses, which, during 2000, reduced our basis in the investment to zero. Accordingly, when Kozmo.com announced its intentions to cease operations in April 2001, we did not have any further loss exposure relating to our investment. We will not recover any portion of our investment in Kozmo.com.

During 2000, we recorded a gain of $40 million relating to the acquisition of Homegrocer.com by Webvan, and a $6 million net gain relating to the bankruptcy of Living.com, Inc. that is comprised of a $14 million loss representing our remaining investment balance in Living.com and a $20 million gain relating to the unamortized portion of unearned revenue associated with the Living.com commercial agreement.

As of December 31, 2001, our recorded basis in equity securities was $41 million, including $13 million classified as Marketable securities, $10 million classified as Investments in equity-method investees, and $18 million classified as Other equity investments.

Equity in Losses of Equity-Method Investees

Equity in losses of equity-method investees represents our share of losses of companies in which we have investments that give us the ability to exercise significant influence, but not control, over an investee. This influence is generally defined as an ownership interest of the voting stock of the investee of between 20% and 50%, although other factors, such as representation on our investee s Board of Directors and the effect of commercial arrangements, are considered in determining whether the equity method of accounting is appropriate. Equity-method losses were $30 million, $305 million and $77 million for 2001, 2000 and 1999, respectively. Equity-method losses declined during 2001 in comparison with 2000 because such losses reduced many of our underlying investment balances until the recorded basis was reduced to zero. Our basis in equity-method investments was $10 million, $52 million and $227 million at December 31, 2001, 2000 and 1999, respectively. During 2001, we issued $5 million of our common stock in exchange for an ownership interest that results in significant influence in Altura International, which operates Catalogcity.com. No cash investments were made in

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equity-method investees during 2001. As equity-method losses are only recorded until the underlying investments are reduced to zero, we expect, absent additional investments in the voting stock of third parties, equity-method losses to continue to decline in future periods in comparison with prior periods.

Income Taxes

We provided for current and deferred income taxes in state and foreign jurisdictions where our subsidiaries produce taxable income. As of December 31, 2001, we have a net deferred tax asset of $2 million, which consists primarily of state net operating losses. We have provided a full valuation allowance against the remaining portion of our deferred tax asset, consisting primarily of net operating losses, because of uncertainty regarding its future realization.

Net Loss

Net loss was $567 million, $1.4 billion and $720 million for 2001, 2000 and 1999, respectively. Although we reported net income of $5 million during the fourth quarter of 2001, we believe that this positive net income result is not predictive of future results or trends and should not be viewed as a material positive event for a variety of reasons. For example, excluding the foreign-currency gain associated with our 6.875% PEACS we would have reported a net loss in the fourth quarter of 2001. Additionally, we continue to be unable to forecast the effect on our future reported results of certain items, including the gain or loss associated with our 6.875% PEACS that will result from fluctuations in foreign exchange rates, and the effect on our results associated with variable accounting treatment on certain of our employee stock options.

Pro Forma Results of Operations

We provide certain pro forma information regarding our results from operations, which excludes the following line items on our statements of operations:

stock-based compensation,

amortization of goodwill and other intangibles, and

restructuring-related and other charges.

We also provide certain pro forma information regarding our net loss, which excludes, in addition to the line items described above, the following line items on our statements of operations:

other gains (losses), net;

equity in losses of equity-method investees, net; and

cumulative effect of change in accounting principle.

This pro forma information is not presented in accordance with accounting principles generally accepted in the United States, however, we use this pro forma measure internally to evaluate our performance and believe it may be useful. For information about our financial results, as reported in accordance with accounting principles generally accepted in the United States, see Item 6 of Part II, Selected Consolidated Financial Data, and Item 8 of Part II, Financial Statements and Supplementary Data.

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Full year and corresponding quarterly pro forma results of operations, and certain cash flow information for 2001, 2000 and 1999, were as follows (in thousands):

	Year Ended December 31, 2001				
	Full Year	**Fourth Quarter**	**Third Quarter**	**Second Quarter**	**First Quarter**
Pro forma income (loss) from operations	$ (45,002)	$ 58,680	$ (27,072)	$ (28,009)	$ (48,601)
Pro forma net income (loss)	$ (157,031)	$ 34,785	$ (58,005)	$ (57,528)	$ (76,283)
Pro forma income (loss) from operations as a percentage of net sales	(1%)	5%	(4%)	(4%)	(7%)
Pro forma basic income (loss) per share	$ (0.43)	$ 0.09	$ (0.16)	$ (0.16)	$ (0.21)
Pro forma diluted income (loss) per share	$ (0.43)	$ 0.09	$ (0.16)	$ (0.16)	$ (0.21)
Shares used in computation of pro forma basic income (loss) per share	364,211	371,420	368,052	359,752	357,424
Shares used in computation of pro forma diluted income (loss) per share	364,211	384,045	368,052	359,752	357,424
Net cash provided by (used in) operating activities	$ (119,782)	$ 349,120	$ (64,403)	$ 2,485	$ (406,984)

	Year Ended December 31, 2000				
	Full Year	**Fourth Quarter**	**Third Quarter**	**Second Quarter**	**First Quarter**
Pro forma loss from operations	$ (317,000)	$ (59,946)	$ (68,439)	$ (89,349)	$ (99,266)
Pro forma net loss	$ (417,158)	$ (90,426)	$ (89,493)	$ (115,704)	$ (121,535)
Pro forma loss from operations as a percentage of net sales	(11%)	(6%)	(11%)	(15%)	(17%)
Pro forma basic and diluted loss per share	$ (1.19)	$ (0.25)	$ (0.25)	$ (0.33)	$ (0.35)
Shares used in computation of pro forma basic and diluted loss per share	350,873	355,681	353,954	349,886	343,884
Net cash provided by (used in) operating activities	$ (130,442)	$ 247,653	$ (3,688)	$ (54,029)	$ (320,378)

	Year Ended December 31, 1999				
	Full Year	**Fourth Quarter**	**Third Quarter**	**Second Quarter**	**First Quarter**
Pro forma loss from operations	$ (352,371)	$ (175,349)	$ (79,198)	$ (67,253)	$ (30,571)
Pro forma net loss	$ (389,815)	$ (184,885)	$ (85,810)	$ (82,786)	$ (36,334)
Pro forma loss from operations as a percentage of net sales	(21%)	(26%)	(22%)	(21%)	(10%)
Pro forma basic and diluted loss per share	$ (1.19)	$ (0.55)	$ (0.26)	$ (0.26)	$ (0.12)
Shares used in computation of pro forma basic and diluted loss per share	326,753	338,389	332,488	322,340	313,794
Net cash provided by (used in) operating activities	$ (90,875)	$ 31,506	$ (75,573)	$ (29,614)	$ (17,194)

The following is a reconciliation of our pro forma results for 2001, 2000 and 1999. Quarterly reconciliations are consistent with full-year presentation.

	Year Ended December 31, 2001			Year Ended December 31, 2000			Year Ended December 31, 1999		
	As Reported(1)	**Pro Forma Adjustments**	**Pro Forma**	**As Reported(1)**	**Pro Forma Adjustments**	**Pro Forma**	**As Reported(1)**	**Pro Forma Adjustments**	**Pro Forma**
		(in thousands)			**(in thousands)**			**(in thousands)**	
Net sales	$ 3,122,433	$	$ 3,122,433	$ 2,761,983	$	$ 2,761,983	$ 1,639,839		$ 1,639,839
Cost of sales	2,323,875		2,323,875	2,106,206		2,106,206	1,349,194		1,349,194
Gross profit	798,558		798,558	655,777		655,777	290,645		290,645
Operating expenses:									
Fulfillment	374,250		374,250	414,509		414,509	237,312		237,312
Marketing	138,283		138,283	179,980		179,980	175,838		175,838
Technology and content	241,165		241,165	269,326		269,326	159,722		159,722
General and administrative	89,862		89,862	108,962		108,962	70,144		70,144
Stock-based compensation	4,637	(4,637)		24,797	(24,797)		30,618	(30,618)	
Amortization of goodwill and intangibles	181,033	(181,033)		321,772	(321,772)		214,694	(214,694)	
Restructuring-related and other	181,585	(181,585)		200,311	(200,311)		8,072	(8,072)	
Total operating expenses	1,210,815	(367,255)	843,560	1,519,657	(546,880)	972,777	896,400	(253,384)	643,016
Loss from operations	(412,257)	367,255	(45,002)	(863,880)	546,880	(317,000)	(605,755)	253,384	(352,371)
Interest income	29,103		29,103	40,821		40,821	45,451		45,451
Interest expense	(139,232)		(139,232)	(130,921)		(130,921)	(84,566)		(84,566)
Other expense, net	(1,900)		(1,900)	(10,058)		(10,058)	1,671		1,671
Other gains (losses), net	(2,141)	2,141		(142,639)	142,639				
Net interest expense and other	(114,170)	2,141	(112,029)	(242,797)	142,639	(100,158)	(37,444)		(37,444)
Loss before equity in losses of equity-method investees	(526,427)	369,396	(157,031)	(1,106,677)	689,519	(417,158)	(643,199)	253,384	(389,815)
Equity in losses of equity-method investees, net	(30,327)	30,327		(304,596)	304,596		(76,769)	76,769	

Loss before cumulative effect of change in accounting principle	(556,754)	399,723	(157,031)	(1,411,273)	994,115	(417,158)	(719,968)	330,153	(389,815)
Cumulative effect of change in accounting principle	(10,523)	10,523							
Net loss	$ (567,277)	$ 410,246	$ (157,031)	$ (1,411,273)	994,115	$ (417,158)	$ (719,968)	330,153	(389,815)
Net cash used in operating activities	$ (119,782)		$ (119,782)	$ (130,442)		$ (130,442)	$ (90,875)		$ (90,875)
Basic and diluted loss per share:									
Prior to cumulative effect of change in accounting principle	$ (1.53)		$ (0.43)	$ (4.02)		$ (1.19)	$ (2.20)		$ (1.19)
Cumulative effect of change in accounting principle	(0.03)								
	$ (1.56)		$ (0.43)	$ (4.02)		$ (1.19)	$ (2.20)		$ (1.19)
Shares used in computation of basic and diluted loss per share	364,211		364,211	350,873		350,873	326,753		326,753

(1) In accordance with accounting principles generally accepted in the United States.

We are providing pro forma results for informational purposes only. The pro forma results are derived from information recorded in our financial statements.

For the quarter ending March 31, 2002, we expect our pro forma loss from operations to be between a loss of $16 million and break-even, or between a loss of 2% to 0% of net sales. For the full year of 2002, we expect that our pro forma income from operations will be $30 million or more. However, any such projections are subject to substantial uncertainty. See Item 1 of Part I, Business Additional Factors That May Affect Future Results.

Liquidity and Capital Resources

Our principal source of liquidity is our cash, cash equivalents, and marketable securities. Our cash and cash equivalents balance was $540 million and $822 million, and our marketable securities balance was $456 million and $278 million at December 31, 2001 and 2000, respectively. Combined cash, cash equivalents, and marketable securities were $997 million and $1.10 billion at December 31, 2001 and 2000, respectively. Equity securities of $13 million are included in Marketable securities at December 31, 2001, the value of which may fluctuate significantly. Equity securities of $36 million were included in Marketable securities at December 31, 2000.

As of December 31, 2001, our principal commitments consisted of long-term obligations totaling $2.16 billion related primarily to our 6.875% PEACS, 4.75% Convertible Subordinated Notes and Senior Discount Notes; trade payables of $445 million; accrued expenses and other liabilities of $305 million, which includes current restructuring-related obligations of $41 million; as well as $474 million in obligations related to operating leases and commitments for advertising and promotional arrangements. We generally have payment terms with our vendors that extend beyond the amount of time necessary to collect proceeds from our customers. As a result of holiday sales, at December 31 of each year our cash, cash equivalents and marketable securities balance reaches its highest level (other than as a result of cash flows provided by investing and financing activities). This operating cycle results in a corresponding increase in accounts payable, which at December 31, 2001 was $445 million. The majority of our accounts payable balance at December 31, 2001 will be settled during the first three months of 2002 and will result in a corresponding decline in the amount of cash, cash equivalents and marketable securities on hand, offset by amounts payable associated with activity in the first quarter of 2002.

We have pledged a portion of our marketable securities as collateral for stand-by letters of credit that guarantee certain of our contractual obligations, a majority of which relates to property leases; the swap agreement that hedges the foreign-exchange rate risk on a portion of our 6.875% PEACS; and some of our real estate lease agreements. The amount of marketable securities we are required to pledge pursuant to the swap agreement fluctuates with the fair market value of the swap obligation. At December 31, 2001, the total amount of collateral pledged under these agreements was as follows (in thousands):

Stand-by letters of credit	$ 77,635
Swap agreement	48,498
Real estate leases	40,657
	$ 166,790

The following are our contractual commitments associated with our operational restructuring, debt obligations, lease obligations, and our marketing agreements (in thousands):

	Year Ending December 31,						
	2002	**2003**	**2004**	**2005**	**2006**	**Thereafter**	**Total**
Restructuring-related commitments:							
Leases	$ 35,578	$ 5,476	$ 2,016	$ 1,983	$ 2,068	$ 6,066	$ 53,187
Other	5,220	3,031					8,251
Restructuring-related commitments	40,798	8,507	2,016	1,983	2,068	6,066	61,438
Other Commitments:							
Debt principal and other	4,775	4,462	2,004	74		2,123,593	2,134,908
Debt interest	109,501	122,704	135,906	135,906	135,906	388,563	1,028,486
Capital leases	11,339	6,573	41				17,953
Operating leases	60,837	57,501	48,729	41,953	42,400	206,373	457,793
Marketing agreements	16,411	217					16,628
Other commitments	202,863	191,457	186,680	177,933	178,306	2,718,529	3,655,768
Total commitments	$ 243,661	$ 199,964	$ 188,696	$ 179,916	$ 180,374	$ 2,724,595	$ 3,717,206

Net cash used by operating activities consists of net loss offset by certain adjustments not affecting current-period cash flows, and the effect of changes in working capital. Adjustments to net income to determine cash flows from operations include depreciation and amortization, equity in losses of investees, and other items not affecting cash flows in the current period. Net cash used by operating activities during 2001 was $120 million, resulting from our net loss of $567 million, offset by adjustments not affecting 2001 cash flows of $412 million, and changes in working capital of $36 million. Net cash used by operating activities during 2000 was $130 million, resulting from our net loss of $1.41 billion, offset by adjustments not affecting 2000 cash flows of $1.10 billion, and changes in working capital of $178 million. Net cash used by operating activities during 1999 was $91 million resulting from our net loss of $720 million, offset by adjustments not affecting 1999 cash flows of $405 million, and changes in working capital of $224 million. Improvements in cash flows from operating activities and an improvement in inventory turns during 2001 were partially offset by slower revenue growth and a decline in the average number of days trade payables remain outstanding due to, among other things, a shift in revenue mix towards segments with shorter payment terms, such as U.S. Electronics, Tools and Kitchen and International.

Cash used in investing activities during 2001 was $253 million, consisting of net purchases of marketable securities of $197 million, purchases of fixed assets of $50 million and cash paid for acquired assets of $6 million. Cash provided by investing activities during 2000 was $164 million, consisting of net sales of marketable securities of $361 million offset by cash paid for investments of $63 million and purchases of fixed assets of $135 million. Cash used in investing activities during 1999 was $952 million, consisting of net purchases of marketable securities of

$295 million, purchases of fixed assets of $287 million and cash paid for investments of $370 million.

Net cash provided by financing activities during 2001 was $107 million, consisting primarily of proceeds from the issuance of common stock to America Online as well as exercises of stock options, offset by repayments of long-term capital lease obligations. Net cash provided by financing activities during 2000 and 1999 was $693 million and $1.10 billion, respectively, consisting primarily of net proceeds from our issuance of debt securities. During 2000, we issued 690 million Euros of 6.875% PEACS, and during 1999 we issued $1.25 billion of 4.75% Convertible Subordinated Notes.

We believe that current cash, cash equivalents and marketable securities balances will be sufficient to meet our anticipated operating cash needs for at least the next 12 months. In addition, we expect to have positive operating cash flow, and possibly free cash flow, for fiscal year 2002. However, any projections of future cash needs and cash flows are subject to substantial uncertainty. See Additional Factors that May Affect Future Results. We continually evaluate opportunities to sell additional equity or debt securities, obtain credit facilities from lenders, or restructure our long-term debt for strategic reasons or to further strengthen our financial

position. The sale of additional equity or convertible debt securities could result in additional dilution to our stockholders. In addition, we will, from time to time, consider the acquisition of or investment in complementary businesses, products, services and technologies, and the repurchase and retirement of debt, which might affect our liquidity requirements or cause us to issue additional equity or debt securities. There can be no assurance that financing will be available in amounts or on terms acceptable to us, if at all.

Strategic Alliances

Beginning in 1999, we offered services to other e-commerce companies including permitting third parties to offer products or services on our Web site, and promotional services such as advertising placements and customer referrals. We may enter into similar transactions in the future. Beginning with our strategic alliance with Toysrus.com in 2000, we began expanding our range of services. We now offer a variety of services to third parties, including offering consumer products sold by us through Syndicated Stores; allowing third parties to utilize our technology services such as search, browse and personalization; and powering third-party Web-sites, providing fulfillment services, or both. In exchange for the services we provide under these agreements, we receive cash and/or equity securities of these companies (additional benefits may include Web site traffic). The amount of compensation we receive under certain of these agreements is dependent on the volume of sales which the other company makes. In some cases, such as our agreement with drugstore.com, we have also made separate investments in the other company by making a cash payment in exchange for equity securities of that company. As part of this program, we may in the future make additional investments in companies with which we have already formed strategic alliances or companies with which we form new strategic alliances or similar arrangements. To the extent we have received equity securities as compensation, fluctuations in the value of such securities will affect our ultimate realization of amounts we have received as compensation for services.

For equity securities of public companies, we generally determine fair value based on the quoted market price at the time we enter into the underlying commercial agreement, and adjust such market price appropriately if significant restrictions on marketability exist. Because an observable market price does not exist for equity securities of private companies, our estimates of fair value of such securities are more subjective than for the securities of public companies. For significant transactions involving equity securities in private companies, we obtain and consider independent, third-party valuations where appropriate. Such valuations use a variety of methodologies to estimate fair value, including comparing the security with securities of publicly traded companies in similar lines of business, applying price multiples to estimated future operating results for the private company, and utilizing estimated discounted cash flows for that company. These valuations also reduce the otherwise fair value by a factor that is intended to account for restrictions on control and marketability where appropriate. Using these valuations and other information available to us, such as our knowledge of the industry and knowledge of specific information about the investee, we determine the estimated fair value of the securities received.

The fair value of these securities, less the net amount of cash we paid for them, is then recorded as unearned revenue. Our recorded unearned revenue resulting from these transactions and any additional proceeds received under the arrangements is recognized as revenue over the terms (generally, one to three years) of the commercial agreements with these companies. Pursuant to EITF Issue No. 00-8, Accounting by a Grantee for an Equity Instrument to Be Received in Conjunction with Providing Goods or Services, we do not adjust unearned revenue to give effect to either an increase or decrease in value of the equity securities subsequent to their initial measurement (to the extent that such securities are either not subject to vesting or forfeiture or, if subject to vesting or forfeiture, were not received or modified after March 16, 2000). Therefore, the value of equity securities recorded as unearned revenue could decline in value significantly after the initial measurement is made. We have in the past, and may in the future, experience losses with respect to investments in strategic companies that are not equity-method investees as a result of either liquidation of such investments at a loss or provision for an other-than-temporary decline in the fair value of these investments. See Other gains (losses), net. In addition, we have in the past, and may in the future, amend our agreements with certain of the companies with which we have strategic alliances to reduce future cash proceeds to be received by us, shorten the term of our commercial agreements, or both. Although these amendments did not affect the amount of unearned revenue

previously recorded by us, the timing of revenue recognition of these recorded unearned amounts has been changed to correspond with the terms of the amended agreements. These amendments or future amendments will affect the timing and amount of revenues recognized in connection with these strategic alliances. To the extent we believe any such amendments cause or may cause the compensation to be received under an agreement to no longer be fixed or determinable, we limit our revenue recognition to amounts received, excluding any future amounts not deemed fixed or determinable. As future amounts are subsequently received, such amounts are incorporated into our revenue recognition over the remaining term of the agreement.

As of December 31, 2001, our recorded basis in equity securities was $41 million, including $13 million classified as Marketable securities, $10 million classified as Investments in equity-method investees, and $18 million classified as Other equity investments.

During 2001 and 2000, activity in unearned revenue was as follows (in thousands):

Balance, December 31, 1999	$ 54,790
Cash received or cash receivable	97,818
Fair value of equity securities received	106,848
Amortization to revenue	(108,211)
Contract termination	(20,128)
Balance, December 31, 2000	131,117
Cash received or cash receivable	114,738
Fair value of equity securities received	331
Amortization to revenue	(135,808)
Contract termination	(22,400)
Balance, December 31, 2001	$ 87,978

During the first quarter of 2001, we recognized previously unearned revenue associated with the termination of our commercial agreement with Kozmo.com, which was included in Other gains (losses), net on our statements of operations. Since services had not yet been performed under the contract, no amounts associated with the Kozmo.com commercial agreement were previously recognized in Net sales on our statements of operations during any period.

During 2000, living.com declared bankruptcy and terminated its commercial agreement with us. As a result, we recorded a net gain of $6 million, comprised of a $14 million impairment loss representing our remaining investment balance in living.com and a $20 million gain relating to the unamortized portion of unearned revenue associated with the living.com commercial agreement as we were no longer obligated to perform services. The gain and the loss are recorded net and included in Other gains (losses), net on our statements of operations.

Item 7A. ***Quantitative and Qualitative Disclosure About Market Risk***

We are exposed to market risk for the effect of interest rate changes, foreign currency fluctuations and changes in the market values of our investments.

Information relating to quantitative and qualitative disclosure about market risk is set forth below and in Management s Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources.

Interest Rate Risk

Our exposure to market risk for changes in interest rates relates primarily to our investment portfolio and our long-term debt. All of our cash equivalent and marketable fixed income securities are designated as available-for-sale and, accordingly, are presented at fair value on our balance sheets. We generally invest our

excess cash in A-rated or higher short- to intermediate-term fixed income securities and money market mutual funds. Fixed rate securities may have their fair market value adversely affected due to a rise in interest rates, and we may suffer losses in principal if forced to sell securities that have declined in market value due to changes in interest rates.

The following table provides information about our cash equivalent and marketable fixed income securities, including principal cash flows by expected maturity, and the related weighted average interest rates at December 31, 2001. Amounts are as follows (in thousands, except percentages):

	2002	2003	2004	2005	2006	Thereafter	Total	Estimated Fair Value at December 31, 2001
Commercial paper and short-term obligations	$ 419,098	$	$	$	$	$	$ 419,098	$ 418,936
Weighted average interest rate	2.33%						2.33%	
Certificates of deposit	18,159						18,159	18,159
Weighted average interest rate	3.48%						3.48%	
Corporate notes and bonds		26,520	7,800				34,320	37,602
Weighted average interest rate		2.98%	4.00%				3.21%	
Asset-backed and agency securities	6,209	73,070	149,765			1,767	230,811	232,821
Weighted average interest rate	2.55%	3.42%	3.63%			7.64%	3.56%	
Treasury notes and bonds	11,900	72,100	36,700				120,700	125,947
Weighted average interest rate	2.05%	2.44%	3.42%				2.70%	
Cash equivalents and marketable fixed-income securities	$ 455,366	$ 171,690	$ 194,265	$	$	$ 1,767	$ 823,088	$ 833,465

The following table provides information about our cash equivalent and marketable fixed income securities, including principal cash flows by expected maturity, and weighted average interest rates at December 31, 2000. Amounts were as follows (in thousands, except percentages):

	2001	2002	2003	2004	2005	Thereafter	Total	Estimated Fair Value at December 31, 2000
Commercial paper and short-term obligations	$ 677,895	$	$	$	$	$	$ 677,895	$ 677,895
Weighted average interest rate	5.40%						5.40%	
Corporate notes and bonds	950	7,937	8,560				17,447	17,447
Weighted average interest rate	4.45%	4.95%	4.95%				4.92%	
Asset-backed and agency securities	21,507	11,718	11,114		19,635	20,747	84,721	85,189
Weighted average interest rate	5.68%	5.96%	4.71%		6.87%	7.39%	6.30%	
Treasury notes and bonds	42,535	74,021	25,595				142,151	142,085
Weighted average interest rate	5.05%	5.22%	4.52%				5.04%	
Cash equivalents and marketable fixed-income securities	$ 742,887	$ 93,676	$ 45,269	$	$ 19,635	$ 20,747	$ 922,214	$ 922,616

At December 31, 2001, we have long-term debt of $2.16 billion primarily associated with our 6.875% PEACS, 4.75% Convertible Subordinated Notes and Senior Discount Notes, which are due in 2010, 2009 and 2008, respectively. Our payment commitments associated with these debt instruments are fixed during the corresponding terms and are comprised of interest payments, principal payments, or a combination thereof. The market value of our long-term debt will fluctuate with movements of interest rates, increasing in periods of declining rates of interest, and declining in periods of increasing rates of interest.

Foreign Currency Exchange Rate Risk

During 2001, net sales from our internationally-focused Web sites (*www.amazon.co.uk, www.amazon.de, www.amazon.fr,* and *www.amazon.co.jp*) accounted for 21% of consolidated revenues. Net sales generated from these Web sites, as well as most of the related expenses incurred, are denominated in the functional currencies of the corresponding Web sites. The functional currency of our subsidiaries that either operate or support *www.amazon.co.uk, www.amazon.de, www.amazon.fr,* and *www.amazon.co.jp* is the same as the local currency

of the United Kingdom, Germany, France and Japan, respectively. Results of operations from our foreign subsidiaries and our subsidiaries that operate our internationally-focused Web sites are exposed to foreign currency exchange rate fluctuations as the financial results of these subsidiaries are translated into U.S. dollars upon consolidation. As exchange rates vary, net sales and other operating results, when translated, may differ materially from expectations. The effect of foreign currency exchange rate fluctuations on the results of operations of our internationally-focused Web sites for 2001 was not material.

At December 31, 2001, we were also exposed to foreign currency risk related to our 6.875% PEACS and Euro-denominated cash equivalents and marketable securities (Euro Investments). The 6.875% PEACS have an outstanding principal balance of 690 million Euros ($609 million, based on the exchange rate as of December 31, 2001), and our Euro Investments, classified as available-for-sale, had a balance of 179 million Euros ($158 million, based on the exchange rate as of December 31, 2001). As the Euro/U.S. dollar exchange ratio varies, the value of our Euro Investments, when translated, will fluctuate. Debt principal of 615 million Euros is remeasured each period, which results in currency gains or losses that are recorded in Other gains (losses), net on our statements of operations. We hedge the exchange rate risk on debt principal of 75 million Euros and a portion of the interest payments using a cross-currency swap agreement. Under the swap agreement, we agreed to pay at inception and receive upon maturity 75 million Euros in exchange for receiving at inception and paying at maturity $67 million. In addition, we agreed to receive in February of each year 27 million Euros corresponding with interest payments on 390 million Euros of the 6.875% PEACS and, simultaneously, to pay $32 million. This agreement is cancelable, in whole or in part, at our option at no cost on or after February 20, 2003 if our common stock price (converted into Euros) is greater than or equal to 84.883 Euros, the minimum conversion price of the 6.875% PEACS. We account for the swap agreement as a cash flow hedge of the risk of exchange rate fluctuations on the debt principal and interest. Gains and losses on the swap agreement are initially recorded in Accumulated other comprehensive loss on our balance sheets and recognized in Other gains (losses), net on our statements of operations upon the recognition of the corresponding currency losses and gains on the remeasurement of the 6.875% PEACS.

Investment Risk

As of December 31, 2001, our recorded basis in equity securities was $41 million, including $13 million classified as Marketable securities, $10 million classified as Investments in equity-method investees, and $18 million classified as Other equity investments. We invest in the stock and/or warrants of both private and public companies, including companies with which we have formed strategic alliances, primarily for strategic purposes. At December 31, 2001, our investments in securities of publicly-held companies was $16 million, and our investments in securities of privately-held companies was $25 million. We have also received securities, including warrant investments, from some of the companies with which we have formed strategic alliances in exchange for services provided by us to those companies. Our investments are accounted for under the equity method if we have the ability to exercise significant influence, but not control, over an investee. Some of our cost-method investments are in private companies and are accounted for at cost and others are in public companies and are accounted for as available-for-sale securities and recorded at fair value. Warrant investments are generally carried at fair value. We regularly review the carrying value of our investments and identify and record losses when events and circumstances indicate that such declines in the fair value of such assets below our accounting basis are other-than-temporary. During 2001, we recorded impairment losses totaling $44 million to write-down several of our equity securities to fair value. All of these investments are in companies involved in the Internet and e-commerce industries and their fair values are subject to significant fluctuations due to volatility of the stock market and changes in general economic conditions. Based on the fair value of the publicly-traded equity securities we held at December 31, 2001, an assumed 15%, 30% or 50% adverse change to market prices of these securities would result in a corresponding decline in total fair value of approximately $6 million, $12 million or $21 million, respectively.

Item 8. ***Financial Statements and Supplementary Data***

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REPORT OF ERNST & YOUNG LLP, INDEPENDENT AUDITORS

The Board of Directors and Stockholders
Amazon.com, Inc.

We have audited the accompanying consolidated balance sheets of Amazon.com, Inc. as of December 31, 2001 and 2000, and the related consolidated statements of operations, stockholders equity (deficit) and cash flows for each of the three years in the period ended December 31, 2001. Our audits also included the financial statement schedule listed at Item 14(a)(2). These financial statements and schedule are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Amazon.com, Inc. at December 31, 2001 and 2000, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2001, in conformity with accounting principles generally accepted in the United States. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

As discussed in Note 1 to the consolidated financial statements, the Company adopted Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities, effective January 1, 2001.

/s/ Ernst & Young LLP

Seattle, Washington
January 18, 2002

AMAZON.COM, INC.

CONSOLIDATED BALANCE SHEETS
(in thousands, except per share data)

	December 31,	
	2001	**2000**
ASSETS		
Current assets:		
Cash and cash equivalents	$ 540,282	$ 822,435
Marketable securities	456,303	278,087
Inventories	143,722	174,563
Prepaid expenses and other current assets	67,613	86,044
Total current assets	1,207,920	1,361,129
Fixed assets, net	271,751	366,416
Goodwill, net	45,367	158,990
Other intangibles, net	34,382	96,335
Investments in equity-method investees	10,387	52,073
Other equity investments	17,972	40,177
Other assets	49,768	60,049
Total assets	$ 1,637,547	$ 2,135,169
LIABILITIES AND STOCKHOLDERS DEFICIT		
Current liabilities:		
Accounts payable	$ 444,748	$ 485,383
Accrued expenses and other current liabilities	305,064	272,683

Unearned revenue	87,978	131,117
Interest payable	68,632	69,196
Current portion of long-term debt and other	14,992	16,577
Total current liabilities	921,414	974,956
Long-term debt and other	2,156,133	2,127,464
Commitments and contingencies		
Stockholders deficit:		
Preferred stock, $0.01 par value:		
Authorized shares 500,000		
Issued and outstanding shares none		
Common stock, $0.01 par value:		
Authorized shares 5,000,000		
Issued and outstanding shares 373,218 and 357,140 shares, respectively	3,732	3,571
Additional paid-in capital	1,462,769	1,338,303
Deferred stock-based compensation	(9,853)	(13,448)
Accumulated other comprehensive loss	(36,070)	(2,376)
Accumulated deficit	(2,860,578)	(2,293,301)
Total stockholders deficit	(1,440,000)	(967,251)
Total liabilities and stockholders deficit	$ 1,637,547	$ 2,135,169

See accompanying notes to consolidated financial statements.

AMAZON.COM, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share data)

	Years Ended December 31,		
	2001	**2000**	**1999**
Net sales	$ 3,122,433	$ 2,761,983	$ 1,639,839
Cost of sales	2,323,875	2,106,206	1,349,194
Gross profit	798,558	655,777	290,645
Operating expenses:			
Fulfillment	374,250	414,509	237,312
Marketing	138,283	179,980	175,838
Technology and content	241,165	269,326	159,722
General and administrative	89,862	108,962	70,144
Stock-based compensation	4,637	24,797	30,618
Amortization of goodwill and other intangibles	181,033	321,772	214,694
Restructuring-related and other	181,585	200,311	8,072
Total operating expenses	1,210,815	1,519,657	896,400
Loss from operations	(412,257)	(863,880)	(605,755)
Interest income	29,103	40,821	45,451

Interest expense	(139,232)	(130,921)	(84,566)
Other income (expense), net	(1,900)	(10,058)	1,671
Other gains (losses), net	(2,141)	(142,639)	
Net interest expense and other	(114,170)	(242,797)	(37,444)
Loss before equity in losses of equity-method investees	(526,427)	(1,106,677)	(643,199)
Equity in losses of equity-method investees, net	(30,327)	(304,596)	(76,769)
Loss before change in accounting principle	$ (556,754)	$ (1,411,273)	$ (719,968)
Cumulative effect of change in accounting principle	(10,523)		
Net loss	$ (567,277)	$ (1,411,273)	$ (719,968)
Basic and diluted loss per share:			
Prior to cumulative effect of change in accounting principle	$ (1.53)	$ (4.02)	$ (2.20)
Cumulative effect of change in accounting principle	(0.03)		
	$ (1.56)	$ (4.02)	$ (2.20)
Shares used in computation of basic and diluted loss per share	364,211	350,873	326,753

See accompanying notes to consolidated financial statements.

AMAZON.COM, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

	Years Ended December 31,		
	2001	**2000**	**1999**
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	$ 822,435	$ 133,309	$ 71,583
OPERATING ACTIVITIES:			
Net loss	(567,277)	(1,411,273)	(719,968)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation of fixed assets and other amortization	84,709	84,460	36,806
Stock-based compensation	4,637	24,797	30,618
Equity in losses of equity-method investees, net	30,327	304,596	76,769
Amortization of goodwill and other intangibles	181,033	321,772	214,694
Non-cash restructuring-related and other	73,293	200,311	8,072
Loss (gain) on sale of marketable securities, net	(1,335)	(280)	8,688
Other losses (gains), net	2,141	142,639	
Non-cash interest expense and other	26,629	24,766	29,171
Cumulative effect of change in accounting principle	10,523		
Changes in operating assets and liabilities:			
Inventories	30,628	46,083	(172,069)
Prepaid expenses and other current assets	20,732	(8,585)	(54,927)
Accounts payable	(44,438)	22,357	330,166
Accrued expenses and other current liabilities	50,031	93,967	95,839
Unearned revenue	114,738	97,818	6,225
Amortization of previously unearned revenue	(135,808)	(108,211)	(5,837)

Interest payable	(345)	34,341	24,878
Net cash used in operating activities	(119,782)	(130,442)	(90,875)
INVESTING ACTIVITIES:			
Sales and maturities of marketable securities	370,377	545,724	2,064,101
Purchases of marketable securities	(567,152)	(184,455)	(2,359,398)
Purchases of fixed assets, including internal use software and web-site development	(50,321)	(134,758)	(287,055)
Investments in equity-method investees and other investments	(6,198)	(62,533)	(369,607)
Net cash provided by (used in) investing activities	(253,294)	163,978	(951,959)
FINANCING ACTIVITIES:			
Proceeds from exercise of stock options and other	16,625	44,697	64,469
Proceeds from issuance of common stock, net of issuance costs	99,831		
Proceeds from long-term debt and other	10,000	681,499	1,263,639
Repayment of long-term debt and other	(19,575)	(16,927)	(188,886)
Financing costs		(16,122)	(35,151)
Net cash provided by financing activities	106,881	693,147	1,104,071
Effect of exchange-rate changes on cash and cash equivalents	(15,958)	(37,557)	489
Net increase (decrease) in cash and cash equivalents	(282,153)	689,126	61,726
CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 540,282	$ 822,435	$ 133,309
SUPPLEMENTAL CASH FLOW INFORMATION:			
Fixed assets acquired under capital leases	$ 4,597	$ 4,459	$ 25,850
Fixed assets acquired under financing agreements	1,000	4,844	5,608
Equity securities received for commercial agreements	331	106,848	54,402
Stock issued in connection with business acquisitions and minority investments	5,000	32,130	774,409
Cash paid for interest	112,184	67,252	30,526

See accompanying notes to consolidated financial statements.

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AMAZON.COM, INC.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY (DEFICIT)
(in thousands)

	Common Stock Shares	Amount	Additional Paid-In Capital	Deferred Stock-Based Compensation	Accumulated Other Comprehensive Income (Loss)	Accumulated Deficit	Total Stockholders Equity (Deficit)
Balance at December 31, 1998	318,534	$ 3,186	$ 297,438	$ (1,625)	$ 1,806	$ (162,060)	$ 138,745
Net loss						(719,968)	(719,968)
Foreign currency translation gains					490		490
Change in unrealized gain (loss) on available-for-sale securities, net					(4,005)		(4,005)
Comprehensive loss							(723,483)
Issuance of capital stock, net of issuance costs	10,496	105	743,169				743,274
Exercise of common stock options, net	16,125	161	67,969				68,130
Public offering of equity-method investee			13,787				13,787
Note receivable for common stock			(72)				(72)

Deferred stock-based compensation, net of adjustments			72,078	(72,078)			
Amortization of deferred stock-based compensation				25,897			25,897
Balance at December 31, 1999	345,155	3,452	1,194,369	(47,806)	(1,709)	(882,028)	266,278
Net loss						(1,411,273)	(1,411,273)
Foreign currency translation losses					(364)		(364)
Change in unrealized gain (loss) on available-for-sale securities, net					(303)		(303)
Comprehensive loss							(1,411,940)
Issuance of capital stock, net of issuance costs	866	8	30,977				30,985
Exercise of common stock options, net	11,119	111	41,995				42,106
Public offering of equity-method investee			76,898				76,898
Note receivable for common stock			27				27
Deferred stock-based compensation, net of adjustments			(5,963)	2,528			(3,435)
Amortization of deferred stock-based compensation				31,830			31,830
Balance at December 31, 2000	357,140	3,571	1,338,303	(13,448)	(2,376)	(2,293,301)	(967,251)
Net loss						(567,277)	(567,277)
Foreign currency translation losses					(1,257)		(1,257)
Change in unrealized gain (loss) on available-for-sale securities, net					7,005		7,005
Net Unrealized losses on Euro-based currency swap					(17,337)		(17,337)
Reclassification of currency gains on 6.875% PEACS					(9,811)		(9,811)
Cumulative effect of change in accounting principle					(12,294)		(12,294)
Comprehensive loss							(600,971)
Issuance of capital stock, net of issuance costs	8,989	90	98,716				98,806
Exercise of common stock options, net	6,089	61	14,989				15,050
Repayments of note receivable for common stock			1,130				1,130
Deferred stock-based compensation, net of adjustments	1,000	10	9,631	(4,797)			4,844
Amortization of deferred stock-based compensation				8,392			8,392
Balance at December 31, 2001	373,218	$ 3,732	$ 1,462,769	$ (9,853)	$ (36,070)	$ (2,860,578)	$ (1,440,000)

See accompanying notes to consolidated financial statements.

AMAZON.COM, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1 DESCRIPTION OF BUSINESS AND ACCOUNTING POLICIES

Description of Business

Amazon.com, Inc. commenced operations on the World Wide Web in July 1995. The Company sells products worldwide, with its principal geographies in North America, Europe and Asia. The Company and its sellers list millions of unique items in categories such as books, music, DVDs, videos, electronics, computers, camera and photo items, software, computer and video games, cell phones and service, tools and hardware, outdoor living items, kitchen and houseware products, toys, baby and baby registry, travel services and magazine subscriptions. Through its Amazon Marketplace, Auctions and zShops services, businesses and individuals can sell virtually any product to Amazon.com s

customer base, and with Amazon.com Payments, sellers are able to accept credit card transactions in addition to other methods of payment. The Company operates a U.S.-based Web site, *www.amazon.com*, and four internationally-focused Web sites: *www.amazon.co.uk*, *www.amazon.de*, *www.amazon.fr* and *www.amazon.co.jp*.

Principles of Consolidation

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All significant intercompany balances and transactions have been eliminated.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Estimates are used for, but not limited to, inventory allowances, depreciation, amortization, sales returns, the accounting for doubtful accounts, unearned revenue, sub-lease income offsetting lease commitments, valuation of investments, taxes and contingencies. Actual results could differ from those estimates.

Business Combinations

For business combinations that have been accounted for under the purchase method of accounting, the Company includes the results of operations of the acquired business from the date of acquisition. Net assets of the companies acquired are recorded at their fair value at the date of acquisition. The excess of the purchase price over the fair value of tangible and identifiable intangible net assets acquired is included in goodwill on the accompanying consolidated balance sheets.

Effective July 1, 2001, pooling-of-interest accounting is no longer allowed under accounting principles generally accepted in the United States. No business combinations were accounted for under this method during 2001, 2000 or 1999.

Cash and Cash Equivalents

The Company classifies all highly liquid instruments with an original maturity of three months or less at the time of purchase as cash equivalents.

Inventories

Inventories, consisting of products available for sale, are recorded using the specific-identification method and valued at the lower of cost or market value.

Fixed Assets

Fixed assets are stated at cost less accumulated depreciation, which includes the amortization of assets recorded under capital leases. Fixed assets, including assets purchased under capital leases, are depreciated on a straight-line basis over the estimated useful lives of the assets (generally two to ten years).

Included in fixed assets is the cost of internal-use software, including software used to develop and operate the Company s Web sites. The Company expenses all costs related to the development of internal-use software other than those incurred during the application development stage. Costs incurred during the application development stage are capitalized and amortized over the estimated useful life of the software (generally two years).

Goodwill and Other Intangibles

Goodwill represents the excess of the purchase price over the fair value of net assets acquired in business acquisitions accounted for under the purchase accounting method. Other intangibles include identifiable intangible assets purchased by the Company, primarily in connection with business acquisitions. Goodwill and other intangibles are presented net of related accumulated amortization and impairment charges and are being amortized over lives ranging from two to four years. Acquisitions subsequent to June 30, 2001 resulting in goodwill and indefinite-lived intangibles are accounted for under a non-amortization approach and are evaluated periodically for impairment.

The Company records impairment losses on goodwill and other intangible assets when events and circumstances indicate that such assets might be impaired and the estimated fair value of the asset is less than its recorded amount. Conditions that would necessitate an impairment assessment include material adverse changes in operations, significant adverse differences in actual results in comparison with initial valuation

forecasts prepared at the time of acquisition, a decision to abandon acquired products, services or technologies, or other significant adverse changes that would indicate the carrying amount of the recorded asset might not be recoverable.

Goodwill is viewed in two separate categories: enterprise-level and business-unit level. Enterprise-level goodwill results from purchase acquisitions of businesses that have been fully integrated into the Company s operations and no longer exist as a discrete business unit. Business-unit goodwill results from purchase business combinations where the acquired operations have been managed as a separate business unit and not fully absorbed into the Company. Enterprise-level goodwill is evaluated using the market-value method, which compares the Company s net book value to the value indicated by the market price of the Company s equity securities; if the net book value were to exceed the Company s market capitalization, the excess carrying amount of goodwill would be written off as an impairment-related charge. Measurement of fair value for business-unit goodwill as well as other intangibles is based on discounted cash flow analysis at the business-unit level.

Investments

The Company has certain investments in debt and equity securities.

Investments are accounted for using the equity method of accounting if the investment gives the Company the ability to exercise significant influence, but not control, over an investee. Significant influence is generally deemed to exist if the Company has an ownership interest in the voting stock of the investee of between 20% and 50%, although other factors, such as representation on the investee s Board of Directors and the effect of

commercial arrangements, are considered in determining whether the equity method of accounting is appropriate. The Company records its equity in the income or losses of these investees generally one month in arrears for private companies and three months in arrears for public companies. The Company records its investments in equity-method investees on the consolidated balance sheets as Investments in equity-method investees and its share of the investees earnings or losses as Equity in losses of equity-method investees, net on the consolidated statements of operations.

All other equity investments, which consist of investments for which the Company does not have the ability to exercise significant influence, are accounted for under the cost method. Under the cost method of accounting, investments in private companies are carried at cost and are adjusted only for other-than-temporary declines in fair value, distributions of earnings and additional investments. For public companies that have readily determinable fair values, the Company classifies its equity investments as available-for-sale and, accordingly, records these investments at their fair values with unrealized gains and losses included in Accumulated other comprehensive loss. Such investments are included in Marketable securities on the accompanying consolidated balance sheets if the Company does not have the intent to hold the investment for over one year from the balance sheet date. In cases where the Company does not have the intent and ability to liquidate such investments within one year from the balance sheet date such investments are included in Other equity investments.

The Company also invests in certain marketable debt securities, which consist primarily of high-quality short- to intermediate-term fixed income securities that are also classified as available-for-sale securities. Such investments are included in Marketable securities on the accompanying consolidated balance sheets and are reported at fair value with unrealized gains and losses included in Accumulated other comprehensive loss. The weighted average method is used to determine the cost of Euro-denominated securities sold, and the specific identification method is used to determine the cost of all other securities.

The initial cost of the Company s investments is determined based on the fair value of the investment at the time of its acquisition. The Company has received equity securities as consideration for services to be performed for the issuer under commercial agreements. In such cases, the Company has estimated the fair value of the equity securities received. For securities of public companies, the Company generally determines fair value based on the quoted market price at the time the Company enters into the underlying agreement, and adjusts such market price appropriately if significant restrictions on marketability exist. As an observable market price does not exist for equity securities of private companies, estimates of fair value of such securities are more subjective than for securities of public companies. For significant transactions involving equity securities in private companies, the Company obtains and considers independent, third party valuations where appropriate. Such valuations use a variety of methodologies to estimate fair value, including comparing the security with securities of publicly traded companies in similar lines of business, applying price multiples to estimated future operating results for the private company, and estimating discounted cash flows for that company. These valuations also reduce the fair value to account for restrictions on control and marketability where appropriate. Using these valuations and other information available to the Company, such as the Company s knowledge of the industry and knowledge of specific information about the investee, the Company determines the estimated fair value of the securities received. To the extent that equity securities received or modified after March 16, 2000 are subject to forfeiture or vesting provisions and no significant performance commitment exists upon signing of the agreements, the fair value of the securities is determined as of the date of the respective forfeiture or as vesting provisions lapse.

The Company periodically evaluates whether the declines in fair value of its investments are other-than-temporary. This evaluation consists of a review of qualitative and quantitative factors by members of senior management. For investments with publicly quoted market prices, the

Company generally considers a decline to be an other-than-temporary impairment if the quoted market price is less than its accounting basis for two

consecutive quarters, absent evidence to the contrary. The Company considers additional factors to determine whether declines in fair value are other-than-temporary, such as the investee s financial condition, results of operations, operating trends and other financial ratios. The evaluation also considers publicly available information regarding the investee companies, including reports from investment analysts and other publicly available investee-specific news or general market conditions. For investments in private companies with no quoted market price, the Company considers similar qualitative and quantitative factors and also considers the implied value from any recent rounds of financing completed by the investee, as well as market prices of comparable public companies. The Company generally requires its private investees to deliver monthly, quarterly and annual financial statements to assist in reviewing relevant financial data and to assist in determining whether such data may indicate other-than-temporary declines in fair value below the Company s accounting basis.

Long-Lived Assets

Long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of the assets might not be recoverable. The Company does not perform a periodic assessment of assets for impairment in the absence of such information or indicators. Conditions that would necessitate an impairment assessment include a significant decline in the observable market value of an asset, a significant change in the extent or manner in which an asset is used, or a significant adverse change that would indicate that the carrying amount of an asset or group of assets is not recoverable. For long-lived assets to be held and used, the Company measures fair value based on quoted market prices or based on discounted estimates of future cash flows. Long-lived assets to be disposed of are carried at fair value less costs to sell.

Unearned Revenue

Unearned revenue is recorded when payments, whether received in cash or equity securities, are received in advance of the Company s performance in the underlying agreement. Unearned revenue is amortized ratably over the period in which services are provided.

In instances where the Company receives equity securities as compensation for services to be provided under commercial arrangements, the fair value of these securities, less the net amount of cash paid for them, is then recorded as unearned revenue. Pursuant to Emerging Issues Task Force Issue No. 00-8, Accounting by a Grantee for an Equity Instrument to Be Received in Conjunction with Providing Goods or Services, the Company does not adjust unearned revenue to give effect to either increase or decrease in value of the equity securities subsequent to their initial measurement (to the extent that such securities are either not subject to vesting or forfeiture or, if subject to vesting or forfeiture, were not received or modified after March 16, 2000).

Income Taxes

The Company recognizes deferred tax assets and liabilities based on differences between the financial reporting and tax bases of assets and liabilities using the enacted tax rates and laws that are expected to be in effect when the differences are expected to be recovered. The Company provides a valuation allowance for deferred tax assets for which it does not consider realization of such assets to be more likely than not.

Revenue Recognition

The Company generally recognizes revenue from product sales or services rendered when the following four revenue recognition criteria are met: persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the selling price is fixed or determinable, and collectibility is reasonably assured.

The Company evaluates the criteria outlined in EITF Issue No. 99-19, Reporting Revenue Gross as a Principal versus Net as an Agent, in determining whether it is appropriate to record the gross amount of product

sales and related costs or the net amount earned as commissions. Generally, when the Company is the primary obligor in a transaction, is subject to inventory risk, has latitude in establishing prices and selecting suppliers, or has several but not all of these indicators, revenue is recorded gross as a principal. If the Company is not the primary obligor and amounts earned are determined using a fixed percentage, a fixed-payment schedule, or a combination of the two, the Company generally records the net amounts as commissions earned.

Product sales (including sales of products through the Company s Syndicates Stores program), net of promotional gift certificates and return allowances, are recorded when the products are shipped and title passes to customers. Return allowances are estimated using historical experience.

Commissions received on sales of products from Amazon Marketplace, Auctions and zShops are recorded as a net amount since the Company is acting as an agent in such transactions. Amounts earned are recognized as net sales when the item is sold by the third-party seller and our collectibility is reasonably assured. The Company records an allowance for refunds on such commissions using historical experience.

The Company earns revenues from services, primarily by entering into business-to-business strategic alliances, including providing the Company s technology services such as search, browse and personalization; permitting third parties to offer products or services through the Company s Web sites; and powering third-party Web sites, providing fulfillment services, or both. These strategic alliances also include miscellaneous marketing and promotional agreements. As compensation for the services the Company provides under these agreements, it receives one or a combination of cash and equity securities. If the Company receives non-refundable, up-front payments, such amounts are deferred until service commences, and are then recognized on a straight-line basis over the estimated corresponding service period. Generally, the fair value of consideration received, whether in cash, equity securities, or a combination thereof, is measured when agreement is reached, and any subsequent appreciation or decline in the fair value of the securities received does not affect the amount of revenue recognized over the term of the agreement. To the extent that equity securities received or modified after March 16, 2000 are subject to forfeiture or vesting provisions and no significant performance commitment exists upon signing of the agreements, the fair value of the securities and corresponding revenue is determined as of the date of the respective forfeiture or as vesting provisions lapse. The Company generally recognizes revenue from these services on a straight-line basis over the period during which the Company performs services under these agreements, commencing at the launch date of the service.

Outbound shipping charges to customers are included in net sales and amounted to $357 million, $339 million and $239 million in 2001, 2000 and 1999, respectively.

Cost of Sales

Cost of sales consists of the purchase price of consumer products sold by the Company, inbound and outbound shipping charges, packaging supplies, and certain costs associated with service revenues. Costs associated with service revenues classified as cost of services generally include direct and allocated indirect fulfillment-related costs to ship products on behalf of third-party sellers, costs to provide customer service, credit card fees and other related costs.

Outbound shipping charges and the cost of tangible supplies used to package products for shipment to customers totaled $376 million, $340 million, and $227 million in 2001, 2000 and 1999, respectively.

Fulfillment

Fulfillment costs represent those costs incurred in operating and staffing the Company s fulfillment and customer service centers, including costs attributable to receiving, inspecting and warehousing inventories; picking, packaging and preparing customers orders for shipment; credit card fees and bad debt costs; variable costs from co-sourcing arrangements; and responding to inquiries from customers.

Marketing

Marketing expenses consist of advertising, promotional and public relations expenditures, and payroll and related expenses for personnel engaged in marketing and selling activities. The Company expenses general media advertising costs as incurred. The Company enters into certain on-line promotional agreements with third parties to increase traffic to its Web sites. Costs associated with these promotional agreement consist of fixed payments, variable activity-based payments, or a combination of the two. Fixed payments are amortized ratably over the corresponding agreement term, and variable payments are expensed in the period incurred. The Company receives reimbursements from vendors for certain general media and other advertising costs. Such reimbursements are classified as a contra-marketing expense. Advertising expense and other promotional costs were $125 million, $172 million and $166 million in 2001, 2000 and 1999, respectively. Prepaid advertising costs were $2 million and $6 million at December 31, 2001 and 2000, respectively.

Technology and Content

Technology and content expenses consist principally of payroll and related expenses for development, editorial, systems and telecommunications operations personnel and consultants; systems and telecommunications infrastructure; and costs of acquired content, including freelance reviews.

Technology and content costs are expensed as incurred, except for certain costs relating to the development of internal-use software, including those relating to operating the Company s Web sites, that are capitalized and depreciated over two years. For the years ended December 31, 2001, 2000 and 1999, capitalized costs related to the development of internal-use software, including those relating to operating the Company s Web sites, net of amortization, were $24 million, $21 million and $7 million, respectively.

Stock-Based Compensation

Stock-based compensation includes stock-based charges resulting from variable accounting treatment of certain options, and option-related deferred compensation recorded at the Company s initial public offering, as well as certain other compensation and severance arrangements. Stock-based compensation also includes the portion of acquisition-related consideration conditioned on the continued tenure of key employees of certain acquired businesses, which must be classified as compensation expense rather than as a component of purchase price under accounting principles generally accepted in the United States.

During the first quarter of 2001, the Company offered a limited non-compulsory exchange of employee stock options that resulted in variable accounting treatment for, at the time of the exchange, approximately 15 million stock options, which includes options granted under the exchange offer and 3 million options, with a weighted average exercise price of $52.41, that were subject to the exchange offer but were not exchanged. Variable accounting will continue until all options subject to variable accounting treatment are exercised, cancelled or expired.

For employee stock awards not subject to variable accounting, the Company recognizes expense based on the intrinsic value of the stock awards granted. Generally, expense is not recorded to the extent individual stock award exercise prices are set equal to or greater than the current market price of the Company s stock on the date of grant.

Foreign Currency

The Company has the following internationally-focused Web sites: *www.amazon.co.uk*, *www.amazon.de*, *www.amazon.fr* and *www.amazon.co.jp.* Net sales generated from these Web sites, as well as most of the related expenses incurred, are denominated in the functional currencies of the Web sites. Additionally, the functional currency of the Company s subsidiaries that either operate or support *www.amazon.co.uk*, *www.amazon.de*, *www.amazon.fr* and *www.amazon.co.jp* is the same as the local currency of the United Kingdom, Germany,

France and Japan, respectively. Assets and liabilities of these subsidiaries are translated into U.S. dollars at year-end exchange rates, and revenues and expenses are translated at average rates prevailing during the year. Translation adjustments are included in Accumulated other comprehensive loss, a separate component of stockholders deficit. Transaction gains and losses arising from transactions denominated in a currency other than the functional currency of the entity involved, which have been insignificant, are included in Other income (expense), net on the consolidated statements of operations.

Derivative Financial Instruments

Effective January 1, 2001, the Company adopted the Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards (SFAS) Accounting for Derivative Instruments and Hedging Activities, (SFAS No. 133), which requires that all derivative instruments be recorded on the balance sheet at fair value. Changes in the fair value of derivatives are recorded each period in current results of operations or other comprehensive income (loss) depending on whether a derivative is designated as part of a hedge transaction and, if it is, the type of hedge transaction. For a derivative designated as a fair value hedge, the gain or loss of the derivative in the period of change and the offsetting loss or gain of the hedged item attributed to the hedged risk are recognized in results of operations. For a derivative designated as a cash flow hedge, the effective portion of the derivative s gain or loss is initially reported as a component of other comprehensive income (loss) and subsequently reclassified into results of operations when the hedged exposure affects results of operations. The ineffective portion of the gain or loss of a cash flow hedge is recognized currently in results of operations. For a derivative not designated as a hedging instrument, the gain or loss is recognized currently in results of operations.

The Company is exposed to the risk of fluctuations in foreign exchange rates between the U.S. dollar and the Euro associated with its 6.875% PEACS (Note 7). To minimize a portion of the risk from this exposure the Company has designated swap and forward agreements as cash flow hedges of a portion of the 6.875% PEACS principal and interest based upon the criteria established by SFAS No. 133. The terms of the hedge instruments have been structured to match the related terms of the hedged portion of the 6.875% PEACS. No net gains or losses, resulting from hedge ineffectiveness, were recognized in results of operations during the year ended December 31, 2001.

The Company holds strategic investments in warrants to purchase equity securities of other companies. Warrants that can be exercised and settled by delivery of net shares such that the Company pays no cash upon exercise (net share warrants) are deemed derivative financial instruments. Net share warrants are not designated as hedging instruments; accordingly, gains or losses resulting from changes in fair value are recognized on the consolidated statements of operations, Other gains (losses), net, in the period of change. The Company determines the fair value of its warrants through option-pricing models using current market price and volatility assumptions, including public-company market comparables for its private-company warrants.

The adoption of SFAS No. 133 on January 1, 2001 resulted in cumulative transition losses of $11 million included in the results of operations and a stockholders deficit adjustment of $12 million. Transition losses included in Cumulative effect of change in accounting principle are attributable to approximately $3 million in losses reclassified from Accumulated other comprehensive loss on warrants previously reported at fair value and classified as available-for-sale, and approximately $8 million in losses on warrants previously reported at cost. No warrant investments are designated as hedging instruments. Transition losses in Accumulated other comprehensive loss are attributable to approximately $15 million in losses on the swap agreement designated as a cash flow hedge of a portion of the 6.875% PEACS offset by the approximately $3 million in losses reclassified to results of operations on derivative instruments not designated as hedging instruments.

Effective January 1, 2001, currency gains and losses arising from the remeasurement of the 6.875% PEACS principal from Euros to U.S. dollars each period are recorded to Other gains (losses), net. Prior to

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January 1, 2001, 6.875% PEACS principal of 615 million Euros was designated as a hedge of an equivalent amount of Euro-denominated investments classified as available-for-sale; accordingly, currency gains and losses on the 6.875% PEACS were recorded to Accumulated other comprehensive loss on the consolidated balance sheets as hedging offsets to currency gains and losses on the Euro-denominated investments. As the hedge does not qualify for hedge accounting under the provisions of SFAS No. 133, commencing January 1, 2001, the foreign currency change resulting from the portion of the 6.875% PEACS previously hedging the available-for-sale securities is now being recorded to Other gains (losses), net on the consolidated statements of operations.

Earnings per Share

Basic earnings per share is computed using the weighted average number of common shares outstanding during the period, net of shares subject to repurchase, and excludes any dilutive effects of options, warrants and convertible securities. Diluted earnings per share is computed using the weighted average number of common and common stock equivalent shares outstanding during the period; common stock equivalent shares are excluded from the computation if their effect is antidilutive.

Recent Accounting Pronouncements

In July 2001, the FASB issued SFAS No. 141, Business Combinations and SFAS No. 142, Goodwill and Other Intangible Assets. SFAS No. 141 requires business combinations initiated after June 30, 2001 to be accounted for using the purchase method of accounting, and broadens the criteria for recording intangible assets separate from goodwill. Recorded goodwill and intangibles will be evaluated against this new criteria and may result in certain intangibles being subsumed into goodwill, or alternatively, amounts initially recorded as goodwill may be separately identified and recognized apart from goodwill. SFAS No. 142 requires the use of a nonamortization approach to account for purchased goodwill and certain intangibles. Under a nonamortization approach, goodwill and certain intangibles will not be amortized into results of operations, but instead would be reviewed for impairment and written down and charged to results of operations only in the periods in which the recorded value of goodwill and certain intangibles is more than its fair value. The provisions of each statement that apply to goodwill and intangible assets acquired prior to June 30, 2001 will be adopted by the Company on January 1, 2002. The Company is in the process of evaluating the financial statement effect of the adoption of these standards and expects it will result in approximately $25 million of other intangibles being subsumed into goodwill and will have the effect of substantially reducing its amortization of goodwill and intangibles commencing January 1, 2002. Transitional impairments, if any, are not expected to be material, however, impairment reviews may result in future periodic write-downs.

The FASB also recently issued SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, that is applicable to financial statements issued for fiscal years beginning after December 15, 2001. The FASB s new rules on asset impairment supersede SFAS No. 121, Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of, and portions of Accounting Principles Bulletin Opinion 30, Reporting the Results of Operations. This Standard provides a single accounting model for long-lived assets to be disposed of and significantly changes the criteria that would have to be met to classify an asset as held-for-sale. Classification as held-for-sale is an important distinction since such assets are not depreciated and are stated at the lower of fair value and carrying amount. This Standard also requires expected future operating losses from discontinued operations to be displayed in the period(s) in which the losses are incurred, rather than as of the measurement date as presently required. The provisions of this Standard are not expected to have a significant effect on the Company s financial position or operating results.

Reclassifications

Certain prior year amounts have been reclassified to conform to the current year presentation.

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Note 2 CASH AND MARKETABLE SECURITIES

The following tables summarize, by major security type, the Company s cash and marketable securities:

Cash and Cash Equivalents

	December 31, 2001			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
	(in thousands)			
Cash	$ 149,968	$	$	$ 149,968
Commercial paper and short-term obligations	394,613		(4,299)	390,314
	$ 544,581	$	$ (4,299)	$ 540,282

	December 31, 2000			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
	(in thousands)			
Cash	$ 141,922	$	$	$ 141,922
Commercial paper and short-term obligations	696,545	87	(18,737)	677,895
Asset-backed and agency securities	2,618			2,618
	$ 841,085	$ 87	$ (18,737)	$ 822,435

Marketable Securities

	December 31, 2001			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
	(in thousands)			
Certificates of deposit	$ 18,692	$	$ (533)	$ 18,159
Commercial paper and short-term obligations	28,614	8		28,622
Corporate notes and bonds	37,370	240	(8)	37,602
Asset-backed and agency securities	231,912	909		232,821
Treasury notes and bonds	125,687	260		125,947
Equity securities	12,395	832	(75)	13,152
	$ 454,670	$ 2,249	$ (616)	$ 456,303

	December 31, 2000			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
	(in thousands)			

Corporate notes and bonds	$ 16,063	$ 1,384	$	$ 17,447
Asset-backed and agency securities	80,748	1,982	(159)	82,571
Treasury notes and bonds	134,646	7,647	(208)	142,085
Equity securities	37,434		(1,450)	35,984
	$ 268,891	$ 11,013	$ (1,817)	$ 278,087

The following table summarizes contractual maturities of the Company s cash equivalent and marketable fixed-income securities as of December 31, 2001:

	Amortized Cost	Estimated Fair Value
	(in thousands)	
Due within one year	$ 454,190	$ 449,391
Due after one year through three years	150,786	151,253
Asset-backed and agency securities with various maturities	231,912	232,821
	$ 836,888	$ 833,465

Gross gains of $9 million, $7 million, and $7 million and gross losses of $32 million, $11 million and $15 million were realized on sales of available-for-sale marketable securities for the years ended December 31, 2001, 2000, and 1999 respectively.

The Company has pledged a portion of its marketable securities as collateral for stand-by letters of credit that guarantee certain of its contractual obligations, a majority of which relates to property leases; the swap agreement that hedges foreign-exchange rate risk on a portion of its 6.875% PEACS; and some of its real estate lease agreements. See Note 7 and Note 8 of these Notes to Consolidated Financial Statements.

Note 3 FIXED ASSETS

Fixed assets, at cost, consist of the following:

	December 31,	
	2001	2000
	(in thousands)	
Computers, equipment and software	$ 205,687	$ 262,103
Internal software, website and content development	62,754	34,358
Leasehold improvements	102,412	107,367
Leased assets	42,444	51,969
Construction in progress	24,846	25,467
	438,143	481,264
Less accumulated depreciation	(152,443)	(99,244)
Less accumulated amortization on leased assets	(13,949)	(15,604)
Fixed assets, net	$ 271,751	$ 366,416

Fixed assets purchased under capital leases consist of computers, equipment and software.

Depreciation expense on fixed assets was $83 million, $83 million and $35 million, which includes amortization of fixed assets acquired under capital lease obligations of $9 million, $11 million and $6 million, for the years ended December 31, 2001, 2000 and 1999, respectively.

Note 4 GOODWILL AND OTHER INTANGIBLES

Goodwill and other intangibles were as follows:

	December 31,	
	2001	2000
	(in thousands)	
Goodwill, net of adjustments	$ 617,827	$ 776,208
Accumulated amortization	(572,460)	(454,433)
Impairment adjustments		(162,785)
Goodwill, net	$ 45,367	$ 158,990
Other intangibles, net of adjustments	$ 221,879	$ 241,357
Accumulated amortization	(187,497)	(123,848)
Impairment adjustments		(21,174)
Other intangibles, net	$ 34,382	$ 96,335

During the fourth quarter of 2000, the Company identified indicators of possible impairment of its recorded goodwill and other intangibles. Such indicators included the general slowdown in the retail economy evidenced by general declines in consumer spending, the Company s decline in market capitalization as determined by the quoted market price for its common stock, the pervasive and significant declines in e-commerce valuations in comparison with the market valuations at the time the Company invested in its acquisitions, and changes in the Company s strategic plans for certain of the acquired businesses. Based on the results of its discounted cash flow analyses, the Company identified certain levels of impairment corresponding with the business-unit goodwill and other intangibles initially recorded in connection with the following acquisitions: Alexa Internet, Back to Basics Toys, Inc., Livebid, Inc., and the catalog and internet assets of Acme Electric Motor Co. (Tool Crib). Accordingly, the Company recorded an impairment loss of $184 million during the fourth quarter of 2000 included in Restructuring-related and other on the consolidated statements of operations.

Note 5 INVESTMENTS

At December 31, 2001, the Company s equity-method investees and the Company s approximate ownership interest in each investee, based on outstanding shares, were as follows:

Company	Percentage Ownership
Altura International	20%
Basis Technology	9
Daksh.com	11
drugstore.com	20
Eziba.com	20

The Company s voting interest in each investee, its representation on the investees Boards of Directors and the effect of commercial arrangements result in the Company having significant influence over the operations of each investee.

Summarized balance sheet information of the Company s equity-method investees (generally one month in arrears for private companies and three months in arrears for public companies) is as follows:

	December 31,	
	2001	2000
	(unaudited) (in thousands)	
Current assets	$ 153,185	$ 279,487
Noncurrent assets	242,728	511,671
Current liabilities	51,652	71,954
Noncurrent liabilities	2,074	113,258

Summarized statement of operations information of the Company s equity-method investees (generally one month in arrears for private companies and three months in arrears for public companies), calculated for each investee for the period during which the Company had investments in such investee, is as follows:

	For the Years Ended December 31,		
	2001	2000	1999
		(unaudited) (in thousands)	
Net sales	$ 155,797	$ 133,821	$ 27,996
Gross profit (loss)	30,226	42,402	(3,072)
Net loss	(160,335)	(453,263)	(152,541)

Activity in the Company s equity-method investments and other equity investments for the years ended December 31, 2000 and 2001, is as follows:

	Equity-Method Investments	Other Equity Investments	Total
		(in thousands)	
Balance, December 31, 1999	$ 226,727	$ 144,735	$ 371,462
Investments cash consideration	48,091	13,485	61,576
Fair value of equity securities received in services-related transactions	80,190	26,658	106,848
Equity-method losses, net	(304,596)		(304,596)
Sales of investments	(41)	(9,163)	(9,204)
Realized gains (losses) on sales of investments	(2,763)	8,156	5,393
Basis adjustments for public offerings of investees	76,898		76,898
Non-cash gain, acquisition of Homegrocer.com, Inc. by Webvan Group, Inc.	40,160		40,160
Loss resulting from Living.com bankruptcy	(14,092)		(14,092)
Losses resulting from other-than-temporary declines in fair value		(100,726)	(100,726)
Unrealized gains on available-for-sale investments, net		693	693
Investment reclassifications, net, at fair value	(98,501)	(43,661)	(142,162)
Balance, December 31, 2000	52,073	40,177	92,250
Investments common stock consideration	5,000		5,000
Fair value of equity securities received in services-related transactions	331		331
Equity-method losses, net	(30,327)		(30,327)
Sales of investments	(800)	(28)	(828)

Realized gains (losses) on sales of investments	800		800
Non-cash gains (losses) for acquisitions of investees by a third party	1,242	(458)	784
Losses resulting from other-than-temporary declines in fair value	(16,696)	(10,189)	(26,885)
Unrealized gains on available-for-sale investments, net		227	227
Losses for change in fair value of warrant investments, net		(5,293)	(5,293)
Loss from change in accounting principle		(7,700)	(7,700)
Investment reclassifications, net, at fair value	(1,236)	1,236	
Balance, December 31, 2001	$ 10,387	$ 17,972	$ 28,359

Effective January 1, 2001 the Company s adoption of SFAS No. 133 resulted in the recording of a loss totaling $8 million to report certain net share warrant investments at fair value. Prior to adoption such warrants were carried at cost.

During 2000, the Company recorded unrealized gains, net of unrealized losses, as additional paid-in capital totaling $77 million as a result of public offerings of common stock by three of the Company s equity method investees at the time, Homegrocer.com, Inc., Pets.com, Inc., and drugstore.com, inc. The unrealized gains, net represent the difference between the Company s carrying basis and the fair value of the portion of each investment deemed to have been sold by the investee.

During 2001 and 2000, reclassifications from Investments in equity method investees resulted from acquisitions of investees by unrelated third parties and the corresponding loss of significant influence over the

investees. Such reclassifications are either to Other equity investments or Marketable securities depending on the marketability of the investments and whether the Company had the intent to hold such investments for over one year from the date of reclassification. During 2000, net reclassifications in Other equity investments are a combination of reclassifications in from Investments in equity method investees and reclassifications out to Marketable securities as the Company no longer had the intent to hold certain investments for over one year from the date of reclassification.

At December 31, 2001 and 2000, Other equity investments included $3 million and $7 million of equity securities and warrant investments recorded at fair value and $15 million and $33 million of equity securities accounted for under the cost-method, respectively. Gross unrealized gains and losses were not significant at December 31, 2001. At December 31, 2000 gross unrealized gains were zero and gross unrealized losses were $3 million.

At December 31, 2001 and 2000, the Company s investments in the common stock of publicly held equity-method investees, at fair value, were $25 million and $12 million, respectively.

Note 6 UNEARNED REVENUE

Activity in unearned revenue was as follows (in thousands):

Balance, December 31, 1999	$ 54,790
Cash received or cash receivable	97,818
Fair value of equity securities received	106,848
Amortization to revenue	(108,211)
Contract termination	(20,128)
Balance, December 31, 2000	131,117
Cash received or cash receivable	114,738
Fair value of equity securities received	331
Amortization to revenue	(135,808)
Contract termination	(22,400)
Balance, December 31, 2001	$ 87,978

During 2001, the Company recognized previously unearned revenue associated with the termination of its commercial agreement with Kozmo.com, which was included in Other gains (losses), net on the accompanying consolidated statements of operations. Since services had not yet been performed under the contract, no amounts associated with the Kozmo.com commercial agreement were previously recognized in Net sales on the accompanying consolidated statements of operations during any period.

During 2000, living.com, Inc. declared bankruptcy and terminated its commercial agreement with the Company. As a result, the Company recorded a net gain of $6 million, comprised of a $14 million loss representing the Company s remaining investment balance in living.com and a $20 million gain relating to the unamortized portion of unearned revenue associated with the living.com commercial agreement. The gain and the loss are recorded net and included in Other gains (losses), net on the accompanying consolidated statements of operations.

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Note 7 LONG-TERM DEBT AND OTHER

The Company s long-term debt and other long-term liabilities are summarized as follows:

	December 31,	
	2001	2000
	(in thousands)	
6.875% PEACS	$ 608,787	$ 650,463
Euro Currency Swap	33,265	
4.75% Convertible Subordinated Notes	1,249,807	1,249,807
Senior Discount Notes	231,830	210,278
Capital Lease Obligations	16,415	24,837
Long-term Restructuring	20,640	
Other Long-term Debt	10,381	8,656
	2,171,125	2,144,041
Less current portion of long-term debt	(5,070)	(4,831)
Less current portion of capital lease obligations	(9,922)	(11,746)
	$ 2,156,133	$ 2,127,464

6.875% PEACS

On February 16, 2000, the Company completed an offering of 690 million Euros of 6.875% PEACS due 2010. The 6.875% PEACS are convertible into the Company s common stock at a conversion price of 84.883 Euros per share. The initial conversion price of the 6.875% PEACS was 104.947 Euros per share, which was adjusted down to the current price on February 16, 2001 due to a reset provision in the note. The conversion price can be reset a final time on February 16, 2002, but in no event will the price be reset lower than the current 84.883 Euros per share. Interest on the 6.875% PEACS is payable annually in arrears in February of each year. The 6.875% PEACS are unsecured and are subordinated to all of the Company s existing and future senior indebtedness. The 6.875% PEACS rank equally with the Company s outstanding 4.75% Convertible Subordinated Notes. Subject to certain conditions, the 6.875% PEACS may be redeemed at the Company s option on or after February 20, 2003, in whole or in part, at the redemption price of 1,000 Euros per note, plus accrued and unpaid interest.

In order to hedge a portion of the risk of exchange rate fluctuations between the U.S. dollar and the Euro, the Company entered into a cross-currency swap agreement and into a series of foreign currency forward purchase agreements in 2000. Under the swap agreement, the Company agreed to pay at inception and receive upon maturity 75 million Euros in exchange for receiving at inception and paying at maturity $67 million. In addition, the Company agreed to receive in February of each year 27 million Euros for interest payments on 390 million Euros of the 6.875% PEACS and, simultaneously, to pay $32 million. The agreement expires February 16, 2010 and is cancelable, in whole or in part, at the Company s option at no cost on or after February 20, 2003 if the Company s underlying stock price (converted into Euros) is greater than or equal to the minimum conversion price of the 6.875% PEACS. The Company has designated the swap agreement as a cash flow hedge of the foreign exchange rate risk on a portion of the 6.875% PEACS principal and interest in accordance with the guidelines of SFAS No. 133 adopted January 1, 2001. Each period, gains or losses resulting from changes in the fair value of the swap contract are recorded to Accumulated other comprehensive loss and a portion of such gain or loss is immediately reclassified to the statement of operations, Other gains (losses), net, to offset the foreign currency loss or gain attributable to remeasurement of the hedged portion of the 6.875% PEACS. For the year ended December

31, 2001, a currency swap loss of $5 million was reclassified to offset a $5 million currency gain on the 6.875% PEACS. The terms of the swap contract have been structured to match the terms of

the hedged portion of the 6.875% PEACS. No net gains or losses, resulting from hedge ineffectiveness, were recognized in results of operations during the year ended December 31, 2001. At December 31, 2001, under the terms of the swap agreement the Company had $48 million of its marketable securities pledged as collateral. Under the forward purchase agreements, the Company agreed to pay $18 million and receive 21 million Euros in February 2001. The Company designated these agreements as cash flow hedges of the foreign exchange rate risk on a portion of the 6.875% PEACS interest payment paid on February 16, 2001. The effect on results of operations, relating to forward purchase agreements for the year ended December 31, 2001, was not significant.

Effective January 1, 2001, currency gains and losses arising from the remeasurement of the 6.875% PEACS s principal from Euros to U.S. dollars each period are recorded to Other gains (losses), net. Prior to January 1, 2001, 6.875% PEACS s principal of 615 million Euros was designated as a hedge of an equivalent amount of Euro-denominated investments classified as available-for-sale; accordingly, currency gains and losses on the 6.875% PEACS were recorded to Accumulated other comprehensive loss on the consolidated balance sheets as hedging offsets to currency gains and losses on the Euro-denominated investments. As the hedge does not qualify for hedge accounting under the provisions of SFAS No. 133, commencing January 1, 2001, the foreign currency change resulting from the portion of the 6.875% PEACS previously hedging the available-for-sale securities is now being recorded to Other gains (losses), net on the consolidated statements of operations. The change resulted in a gain of $47 million for the year ended December 31, 2001, consisting of a $10 million gain reclassified from Accumulated other comprehensive loss and a $37 million gain attributable to remeasurement of the 6.875% PEACS during the period.

The fair value of the swap is determined as the present value of net future cash payments and receipts, adjusted for the Company s ability to cancel the agreement and the likelihood of such cancellation. The fair value takes into consideration current foreign currency exchange rates, market interest rates and the current market price of the Company s common stock. The fair value of the swap obligation was $33 million and $11 million at December 31, 2001 and December 31, 2000, respectively. No forward purchase agreements were outstanding at December 31, 2001. The fair value of the forward purchase agreements, as of December 31, 2000, was $1 million. Based upon quoted market prices, the fair value of the 6.875% PEACS, as of December 31, 2001 and December 31, 2000 was $310 million and $248 million, respectively.

4.75% Convertible Subordinated Notes

On February 3, 1999, the Company completed an offering of $1.25 billion of 4.75% Convertible Subordinated Notes due 2009. The 4.75% Convertible Subordinated Notes are convertible into the Company s common stock at the holders option at a conversion price of $78.0275 per share, subject to adjustment in certain events. Interest on the 4.75% Convertible Subordinated Notes is payable semi-annually in arrears on February 1 and August 1 of each year, and commenced August 1, 1999. The 4.75% Convertible Subordinated Notes are unsecured and are subordinated to all existing and future Senior Indebtedness as defined in the indenture governing the 4.75% Convertible Subordinated Notes. At any time on or after February 6, 2002 on at least 30 days notice the Company may redeem the notes, in whole or in part, at a premium of 3.325% over its principal balance, together with accrued interest. The redemption premium is thereafter reduced by 0.475% on each February 1 between 2003 and 2009.

Upon the occurrence of a fundamental change (as defined in the indenture governing the 4.75% Convertible Subordinated Notes) prior to the maturity of the 4.75% Convertible Subordinated Notes, each holder thereof has the right to require the Company to redeem all or any part of such holder s 4.75% Convertible Subordinated Notes at a price equal to 100% of the principal amount of the notes being redeemed, together with accrued interest.

Based upon quoted market prices, the fair value of the 4.75% Convertible Subordinated Notes as of December 31, 2001 and December 31, 2000 was $625 million and $471 million, respectively.

Senior Discount Notes

In 1998, the Company completed the offering of approximately $326 million of 10% Senior Discount Notes due May 1, 2008 (Original Senior Discount Notes). Pursuant to a registration statement on Form S-4 in September 1998, the Company completed an exchange offer of 10% Senior Discount Notes due 2008 (Exchange Notes or Senior Discount Notes), which are registered under the Securities Act of 1933, as amended, for all outstanding Original Senior Discount Notes. The Exchange Notes have identical terms in all material respects to the terms of the Original Senior Discount Notes, except that the Exchange Notes generally are freely transferable (the Exchange Notes are referred to throughout these notes to consolidated financial statements interchangeably with the Original Senior Discount Notes). The Exchange Notes were issued under the

indenture governing the Original Senior Discount Notes (Indenture). The Original Senior Discount Notes were sold at a substantial discount from their principal amount at maturity of $530 million. Prior to November 1, 2003, no cash interest payments are required; instead, interest will accrete during this period to the aggregate principal amount at maturity. From and after May 1, 2003, the Senior Discount Notes will bear interest at a rate of 10% per annum payable in cash on each May 1 and November 1. The Senior Discount Notes are redeemable, at the option of the Company, in whole or in part, at any time on or after May 1, 2003, at the redemption prices set forth in the Indenture, plus accrued interest, if any, to the date of redemption.

During 1999, the Company repurchased $266 million (principal amount) of the Senior Discount Notes, representing accreted value of $178 million. The Company recorded an immaterial loss on extinguishment of this debt. No repurchases of Senior Discount Notes occurred in 2001 or 2000.

The Senior Discount Notes are senior unsecured indebtedness of the Company ranking equally with the Company s existing and future unsubordinated, unsecured indebtedness and senior in right of payment to all subordinated indebtedness of the Company. The Senior Discount Notes are effectively subordinated to all secured indebtedness and to all existing and future liabilities of the Company s subsidiaries.

The Indenture contains certain covenants that, among other things, limit the ability of the Company and its Restricted Subsidiaries (as defined in the Indenture) to incur indebtedness, pay dividends, prepay subordinated indebtedness, repurchase capital stock, make investments, create liens, engage in transactions with stockholders and affiliates, sell assets and engage in mergers and consolidations. However, these limitations are subject to a number of important qualifications and exceptions. The Company was in compliance with all financial covenants at December 31, 2001 and 2000.

Based upon quoted market prices, the fair value of the outstanding Senior Discount Notes as of December 31, 2001 and December 31, 2000 was $194 million and $134 million, respectively.

Note 8 COMMITMENTS AND CONTINGENCIES

Commitments

The Company currently leases office and fulfillment center facilities and fixed assets under noncancelable operating and capital leases. Rental expense under operating lease agreements for 2001, 2000 and 1999 was $81 million, $98 million and $43 million, respectively.

Future minimum commitments are as follows:

	Restructuring-Related Commitments				Other Commitments			
	Leases	Termination Benefits	Other	Sub-Total	Capital Leases	Operating Leases	Marketing Agreements	Total
	(in thousands)							
Year Ending December 31,								
2002	$ 35,578	$ 61	$ 5,159	$ 40,798	$ 11,339	$ 60,837	$ 16,411	$ 129,385
2003	5,476		3,031	8,507	6,573	57,501	217	72,798
2004	2,016			2,016	41	48,729		50,786
2005	1,983			1,983		41,953		43,936
2006	2,068			2,068		42,400		44,468
Thereafter	6,066			6,066		206,373		212,439
Total estimated cash outflows	$ 53,187	$ 61	$ 8,190	$ 61,438	$ 17,953	$ 457,793	$ 16,628	$ 553,812
Less imputed interest					(1,538)			
Present value of net minimum lease payments					16,415			
Less current portion					(9,922)			
Long-term capital lease obligation					$ 6,493			

At December 31, 2001, the Company remains obligated under gross lease obligations of $121 million associated with its operational restructuring and anticipates receiving sub-lease income of $68 million to offset these obligations, of which $17 million are to be received under non-cancelable subleases.

Stand-by Letters of Credit

At December 31, 2001, the Company pledged marketable securities of $78 million as collateral for stand-by letters of credit that guarantee certain of its contractual obligations, a majority of which relates to property leases. In addition, under the terms of certain real estate lease agreements, the Company has pledged $41 million of its marketable securities.

Legal Proceedings

As previously disclosed in our Quarterly Report on Form 10-Q for the third quarter of 2000, we have received informal inquiries from the staff of the Securities and Exchange Commission Staff (the SEC) with respect to the accounting treatment and disclosures for some of our initial strategic alliances and have been cooperating with the SEC staff in responding to those inquiries. We reviewed our accounting treatment for the transactions with our independent auditors and the SEC staff, and we believe our accounting treatment and disclosures were appropriate. The SEC staff recently notified us that it believes the other party to one such transaction, Ashford.com, improperly reported the resolution of a business dispute with us, and that it is considering whether the Company, or any of its officers or employees may have facilitated Ashford.com s

conduct. While there can be no assurance that the SEC will not pursue an enforcement action, we believe our actions at all times were proper and that this matter will not materially affect our results of operations or financial condition.

On April 12, 2001, the Company received a request from the SEC staff for the voluntary production of documents and information concerning, among other things, previously reported sales of the Company s common stock by Jeffrey Bezos on February 2 and 5, 2001. The Company is cooperating with the SEC staff s continuing inquiry.

A number of purported class action complaints were filed by holders of Amazon.com equity and debt securities against the Company, its directors and certain of its senior officers during 2001, in the United States District Court for the Western District of Washington, alleging violations of the Securities Act of 1933 (the 1933 Act) and/or the Securities Exchange Act of 1934 (the 1934 Act). On October 5, 2001, plaintiffs in the 1934 Act cases filed a consolidated amended complaint alleging that the Company, together with certain of its officers and directors and certain third-parties, made false or misleading statements during the period from October 29, 1998 through July 23, 2001 concerning the Company s business, financial condition and results, inventories, future prospects, and strategic alliance transactions. The 1933 Act complaint alleges that the defendants made false or misleading statements in connection with the Company s February 2000 offering of the 6.875% PEACS. The complaints seek recissionary and/or compensatory damages and injunctive relief against all defendants. The Company disputes the allegations of wrongdoing in these complaints and intends to vigorously defend itself in these matters.

Depending on the amount and the timing, an unfavorable resolution of some or all of these matters could materially affect the Company s business, future results of operations, financial position or cash flows in a particular period.

From time to time, the Company is subject to other legal proceedings and claims in the ordinary course of business, including claims of alleged infringement of trademarks, copyrights, patents and other intellectual property rights. The Company currently is not aware of any such legal proceedings or claims that management believes will have, individually or in the aggregate, a material adverse effect on the Company s business, financial condition or operating results.

Inventory Suppliers

During 2001, approximately 21% of all inventory purchases were made from three major vendors, of which Ingram Book Group accounts for over 10%. The Company does not have long-term contracts or arrangements with most of its vendors to guarantee the availability of merchandise, particular payment terms or the extension of credit limits.

Note 9 STOCKHOLDERS EQUITY (DEFICIT)

Preferred Stock

The Company has authorized 500,000,000 shares of $0.01 par value Preferred Stock. No preferred stock shares were outstanding during 2001, 2000 or 1999.

Common Stock

On January 4, 1999, the Company effected a 3-for-1 stock split in the form of a stock dividend to the stockholders of record on December 18, 1998. On September 1, 1999, the Company effected a 2-for-1 stock split in the form of a stock dividend to stockholders of record on August 12, 1999. The accompanying consolidated financial statements reflect these stock splits.

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Stock Option Plans

The Company s stock option plans consist of the 1999 Nonofficer Employee Stock Option Plan, the 1997 Stock Incentive Plan and the Amended and Restated 1994 Stock Option Plan. Shares reserved under these Plans at December 31, 2001 consist of 40 million shares in the 1999 Nonofficer Employee Stock Option Plan, 94 million shares in the 1997 Stock Incentive Plan and 58 million shares in the 1994 Stock Option Plan, of which up to a maximum of 21,025,075 shares that are not issued under that plan may be added to the aggregate number of shares available for issuance under the 1997 Stock Incentive Plan. In connection with certain acquisitions in 1999, the Company assumed outstanding options to purchase common stock originally issued under the acquired companies stock option plans. The Company s stock option plans as well as the assumed stock option plans are hereby collectively referred to as the Plans.

Generally, the Company s Board of Directors grants options at an exercise price of not less than the fair market value of the Company s common stock at the date of grant. Each outstanding option granted prior to December 20, 1996 has a term of five years from the date of vesting. Generally, outstanding options granted on or subsequent to December 20, 1996 have a term of 10 years from the date of grant. Subject to Internal Revenue Service limitations, options granted under the Company s plans prior to April 1999 and granted under certain assumed plans generally became exercisable immediately but are subject to a restriction on transfer that vests over a period of time. Options granted under the Plans since April 1999 generally vest and become exercisable in accordance with the following vesting schedule: 20% after year one, 20% after year two and 5% at the end of each quarter for years three through five. Certain outstanding options that were granted during 2000 and 2001 vest and become exercisable at the rate of 50% after year one and 50% after year two. During the first quarter of 2001, the Company offered a limited non-compulsory exchange of employee stock options to employees meeting certain eligibility criteria. Options granted pursuant to this stock option exchange vest and become exercisable at the rate of 25% after 6 months from the date of grant and 4.166% per month for the succeeding 18 months. Certain options granted in the third quarter of 2001 generally vest and become exercisable as follows: (i) the option vests quarterly in equal installments over a 36, 48 or 60 month period commencing on dates ranging from grant date to October 1, 2003, (ii) the option vests 5% to 12.5% on a date approximately 12 to 16 months from date of grant with the balance vesting quarterly in equal installments over a 48 to 60 month period or (iii) the option vests 4% to 12.5% on dates approximately 6 months and 18 months from the date of grant with the balance vesting quarterly in equal installments over a 24 or 60 month period. Shares issued upon exercise of options that are unvested are restricted and subject to repurchase by the Company at the exercise price upon termination of employment or services and such restrictions lapse over the original vesting schedule. At December 31, 2001, approximately 1.1 million shares of restricted common stock, which includes restricted shares issued in connection with acquisitions, as well as shares issued to certain key employees in 2001, were subject to repurchase or forfeiture.

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Stock Option Activity

The following table summarizes the Company s stock option activity:

	Number of Shares	Weighted Average Exercise Price
	(in thousands)	
Balance January 1, 1999	76,009	$ 6.69
Options granted and assumed	31,379	63.60
Options canceled	(11,281)	19.70
Options exercised	(16,125)	4.00
Balance December 31, 1999	80,342	27.76
Options granted and assumed	20,717	38.13
Options canceled	(19,502)	37.19
Options exercised	(11,119)	4.02

Balance December 31, 2000	70,438	32.17
Net effect of option exchange:		
Options granted	12,503	13.38
Options exchanged and canceled	(31,170)	51.94
Net effect of option exchange	(18,667)	
Options granted	33,706	8.10
Options canceled	(13,438)	25.29
Options exercised	(6,089)	2.73
Balance December 31, 2001	65,950	10.65

At December 31, 2001, 63 million shares of common stock were available for future grant under the Plans.

The following table summarizes information about options outstanding and exercisable at December 31, 2001:

		Options Outstanding			Options Exercisable	
Range of Exercise Prices		Number of Options	Remaining Life (yrs)	Weighted Average Exercise Price	Number of Options	Weighted Average Exercise Price
		(in thousands)			(in thousands)	
$ 0.03	$ 1.00	5,000	5.0	$ 0.42	4,222	$ 0.39
1.17	5.37	5,095	5.9	4.01	1,943	3.85
5.81	7.86	4,838	6.8	7.13	2,360	7.11
7.93	7.93	26,071	9.7	7.93		7.93
7.95	8.55	3,660	8.5	8.51	263	8.23
8.72	13.24	1,872	8.2	11.40	471	11.86
13.38	13.38	10,712	1.8	13.38	4,227	13.38
13.57	19.89	3,602	7.3	16.76	1,575	17.04
20.06	104.97	5,100	7.7	35.77	1,903	30.53
0.03	104.97	65,950	7.1	10.65	16,964	[illegible]

Foreign currency effect on cash	(6)	(1,058)	(243)
NET CHANGE IN CASH AND CASH EQUIVALENTS	(202,873)	210,665	(51,583)
CASH AND CASH EQUIVALENTS — Beginning of year	$ 332,977	$ 122,312	173,895
CASH AND CASH EQUIVALENTS — End of year	$ 130,104	$ 332,977	$ 122,312

Supplemental

disclosure of non-cash activities			
Issuance of common stock in connection with the AppliedMicro Acquisition (See Note 3 - Acquisitions)	$ 465,082	$ —	$ —

See notes to consolidated financial statements.

MACOM TECHNOLOGY SOLUTIONS HOLDINGS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
1. DESCRIPTION OF BUSINESS
MACOM Technology Solutions Holdings, Inc. (the Company) was incorporated in Delaware on March 25, 2009. We are a leading provider of high-performance analog semiconductor solutions that enable next-generation Internet applications, the cloud connected apps economy, and the modern, networked battlefield across the radio frequency (RF), microwave, millimeterwave and lightwave spectrum. We design and manufacture differentiated, high-value products for customers who demand high performance, quality and reliability.
2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES
Principles of Consolidation, Basis of Presentation and Reclassification—We have one reportable segment, semiconductors and modules. The accompanying consolidated financial statements include our accounts and the accounts of our majority-owned subsidiaries. Certain prior period financial statement amounts, such as debt and leases payable and deferred revenue have been adjusted to conform to currently reported presentations. All intercompany balances and transactions have been eliminated in consolidation.
We have a 52 or 53-week fiscal year ending on the Friday closest to the last day of September. The fiscal years 2017, 2016 and 2015 included 52 weeks. To offset the effect of holidays, for fiscal years in which there are 53 weeks, we typically include the extra week arising in our fiscal years in the first quarter.
Use of Estimates—The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the U.S. requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities during the reporting periods, the reported amounts of revenue and expenses during the reporting periods and the disclosure of contingent assets and liabilities at the date of the financial statements. On an ongoing basis, we base estimates and assumptions on historical experience, currently available information and various other factors that management believes to be reasonable under the circumstances. Actual results may differ from these estimates and assumptions.
Discontinued Operations— In the second quarter of fiscal year 2017, we announced a plan to divest AppliedMicro's compute business (the Compute business). In the fourth quarter of fiscal year 2015, we divested our Automotive business. The operating results of these businesses are reflected in discontinued operations.
Foreign Currency Translation and Remeasurement—Our consolidated financial statements are presented in U.S. dollars. While the majority of our foreign operations use the U.S. dollar as the functional currency, the financial statements of our foreign operations for which the functional currency is not the U.S. dollar are translated into U.S. dollars at the exchange rates in effect at the balance sheet dates (for assets and liabilities) and at average exchange rates (for revenue and expenses). The unrealized translation gains and losses on the net investment in these foreign operations are accumulated as a component of other comprehensive income (loss).
The financial statements of our foreign operations where the functional currency is the U.S. dollar, but where the underlying transactions are transacted in a different currency, are remeasured at the exchange rate in effect at the balance sheet date with respect to monetary assets and liabilities. Nonmonetary assets and liabilities, such as inventories and property and equipment and related statements of operations accounts, such as cost of revenue and depreciation, are remeasured at historical exchange rates. Revenue and expenses, other than cost of revenue, amortization and depreciation, are translated at the average exchange rate for the period in which the transaction occurred. The net gains and losses on foreign currency remeasurement are reflected in selling, general and administrative expense in the accompanying consolidated statements of operations. Net foreign exchange transaction gains and losses for all periods presented were immaterial.
Cash and Cash Equivalents—Cash equivalents are primarily composed of short-term, highly-liquid instruments with an original maturity of three months or less and consist primarily of money market funds and commercial paper.
Investments—We classify our investments as available-for-sale. Our investments classified as available-for-sale are recorded at fair value based upon third party pricing at period end. Unrealized gains and losses that are deemed temporary in nature are recorded in accumulated other comprehensive income and loss as a separate component of stockholders' equity.

A decline in the fair value of any security below cost that is deemed other than temporary results in a charge to earnings and the corresponding establishment of a new cost basis for the security. Premiums and discounts are amortized (accreted) over the life of the related security as an adjustment to its yield. Dividend and interest income are recognized when earned. Realized gains and losses are included in earnings and are derived using the specific identification method for determining the cost of investments sold.

Inventories—Inventories are stated at the lower of cost or market. We use a combination of standard cost and moving weighted-average cost methodologies to determine the cost basis for our inventories, approximating a first-in, first-out basis. The standard cost of finished goods and work-in-process inventory is composed of material, labor and manufacturing overhead, which approximates actual cost. In addition to stating inventory at the lower of cost or market, we also evaluate inventory each reporting period for excess quantities and obsolescence, establishing reserves when necessary based upon historical experience, assessment of economic conditions and expected demand. Once recorded, these reserves are considered permanent adjustments to the carrying value of inventory.

Property and Equipment—Property and equipment are stated at cost, less accumulated depreciation and amortization. Expenditures for maintenance and repairs are charged to expense as incurred, whereas major improvements that significantly extend the useful life of the assets are capitalized as additions to property and equipment.
Property and equipment are depreciated or amortized using the straight-line method over the following estimated useful lives:

Asset Classification	Estimated Useful Life In Years
Buildings and improvements	20 – 40
Machinery and equipment	2 – 7
Computer equipment and software	2 – 5
Furniture and fixtures	7 – 10
Leasehold improvements	Shorter of useful life or term of lease

Goodwill and Indefinite-Lived Intangible Assets—We have goodwill and certain intangible assets with indefinite lives which are not subject to amortization; these are reviewed for impairment annually as of the end of our August fiscal month end and more frequently if events or changes in circumstances indicate that the assets may be impaired. For our assessment of goodwill impairment, we compare the carrying value of the reporting unit to the fair value of the Company. For our assessment of in-service indefinite-lived assets we compare the carrying value of the asset to the estimated fair value of the asset. For indefinite-lived assets not in service, such as in-process research and development, we perform both qualitative and quantitative assessments using an assumption of "more likely than not" to determine if there are any impairment indicators. If impairment exists, a loss is recorded to write down the value of the assets to their implied fair values. During the fiscal year ended September 29, 2017, we recorded impairment charges of $4.4 million related to indefinite-lived intangible assets. See Note 16 - Intangible Assets, for further detail of these impairment charges. There were no significant expenses related to abandoned in-process research and development projects in any prior period presented.
Impairment of Long-Lived Assets—Long-lived assets include property and equipment and definite-lived intangible assets subject to amortization. We evaluate long-lived assets for recoverability when events or changes in circumstances indicate that their carrying amounts may not be recoverable. Circumstances which could trigger a review include, but are not limited to, significant decreases in the market price of the asset or asset group, significant adverse changes in the business climate or legal factors, the accumulation of costs significantly in excess of the amount originally expected for the acquisition or construction of the asset, current period cash flow or operating losses combined with a history of losses or a forecast of continuing losses associated with the use of the asset and a current expectation that the asset will more likely than not, be sold or disposed of significantly before the end of its previously estimated useful life.
In evaluating a long-lived asset for recoverability, we estimate the undiscounted cash flows expected to result from our use and eventual disposition of the asset. If the sum of the expected undiscounted cash flows is less than the carrying amount of the asset, an impairment loss, equal to the excess of the carrying amount over the fair value of the asset, is recognized. In fiscal year 2016 we recorded impairment charges of $13.8 million related to our strategic decision to exit a product line and end programs associated with our GaN-on Silicon Carbide (GaN-on-SiC) license and technology transfer. There were no impairments of definite life long-lived assets in any other periods presented.
Intangible assets related to in-process research and development acquired are not amortized until the underlying asset begins revenue-generating activity, at which time it is amortized over its estimated useful life. Intangibles related to abandoned in-process research and development projects are expensed in the period the project is abandoned.
Other Intangible Assets—Our other intangible assets, including acquired technology and customer relationships, are definite-lived assets and are subject to amortization. We amortize definite-lived assets over their estimated useful lives, which range from five to fourteen years, generally based on the pattern over which we expect to receive the economic benefit from these assets.

Revenue Recognition—We recognize revenue when: (i) persuasive evidence of an arrangement exists; (ii) delivery or services have been rendered; (iii) the price is fixed or determinable; and (iv) collectability is reasonably assured. We recognize revenue with the transfer of title and risk of loss and provide for reserves for returns and other allowances. We generally do not provide customers other than distributors the right to return product, with the exception of warranty related matters. Shipping and handling fees billed to customers are recorded as revenue while the related costs are classified as a component cost of revenue. We provide warranties for certain products and accrue the costs of warranty claims in the period the related revenue is recorded.

Prior to fiscal year 2015, we had concluded that we had insufficient information as well as limited experience in estimating the effect of the right of distributors to return product and price protection and, accordingly, used the sell through approach of revenue recognition. Under this approach, we would recognize revenue from sales after the distributor resold the product to its end customer (the

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sell through basis). After concluding an extensive three year study of distributor related transactions, we completed an evaluation of our revenue recognition policy and concluded that it was appropriate to recognize revenue to distributors at the time of shipment to the distributor (sell-in basis).

During fiscal year 2015, we concluded that we had sufficient data to predict future price adjustments from distributors and had a basis of being able to reasonably estimate these future price adjustments. Accordingly, on a consolidated basis, revenue from distribution customers was impacted by a change in estimate. Revenues from distributors accounted for approximately 10-15% of total consolidated revenue at that time. The terms of certain agreements with distribution customers provide for rights of return and compensation credits until such time as our products are sold by the distributors to their end customers. We have agreements with some distribution customers for various programs, including compensation, volume-based pricing, obsolete inventory, new products and stock rotation. Sales to these distribution customers, as well as the existence of compensation programs, are in accordance with terms set forth in written agreements with these distribution customers. In general, credits allowed under these programs are capped based upon individual distributor agreements. We record charges associated with these programs as a reduction of revenue at the time of sale with a corresponding adjustment to accounts receivable based upon historical activity. Our policy is to use a 12 months rolling historical experience rate and an estimated general reserve percentage in order to estimate the necessary allowance to be recorded.

During the fiscal year ended October 2, 2015, we recorded corresponding adjustments related to this change in estimate to recognize previously deferred revenues. The full-year impact of this change in estimate resulted in additional revenue of $17.4 million and a net income of $7.7 million, or $0.15 earnings per share during fiscal year 2015. We also established a new reserve of $6.0 million for the fiscal year ended October 2, 2015 related to future rebates and returns under various programs associated with our distributor agreements.

Research and Development Costs—Costs incurred in the research and development of products are expensed as incurred.

Income Taxes—Deferred tax assets and liabilities are recognized based on temporary differences between the financial reporting and income tax bases of assets and liabilities, using rates anticipated to be in effect when such temporary differences reverse. A valuation allowance against net deferred tax assets is required if, based upon the available evidence, it is more likely than not that some or all of the deferred tax assets will not be realized.

We provide reserves for potential payments of tax to various tax authorities related to uncertain tax positions and other issues. Reserves are based on a determination of whether and how much of a tax benefit is taken by us in our tax filings or positions that are more likely than not to be realized following an examination by taxing authorities. We recognize the financial statement benefit of an uncertain tax position only after considering the probability that a tax authority would sustain the position in an examination. For tax positions meeting a “more-likely-than-not” threshold, the amount recognized in the financial statements is the benefit expected to be realized upon settlement with the tax authority. For tax positions not meeting the threshold, no financial statement benefit is recognized. Potential interest and penalties associated with such uncertain tax positions are recorded as a component of income tax expense.

Earnings Per Share—Basic net (loss) income per share is computed by dividing net (loss) income by the weighted-average number of common shares outstanding during the period, excluding the dilutive effect of common stock equivalents. Diluted net income (loss) per share reflects the dilutive effect of common stock equivalents, such as stock options, warrants and restricted stock units, using the treasury stock method.

Fair Value Measurements—Financial assets and liabilities are measured at fair value. Fair value is an exit price, representing the amount that would be received from the sale of an asset or paid to transfer a liability at the measurement date under current market conditions in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or liability. As a basis for considering such assumptions, we group financial assets and liabilities in a three-tier fair value hierarchy, according to the inputs used in measuring fair value as follows:

Level 1—observable inputs such as quoted prices in active markets for identical assets and liabilities; Level 2—inputs other than quoted prices in active markets that are observable either directly or indirectly, such as quoted prices in active markets for similar assets and liabilities, quoted prices for identical assets and liabilities in markets that are not

active and model-based valuation techniques for which significant assumptions are observable in active markets; and, Level 3—unobservable inputs for which there is little or no market data, requiring us to develop our own assumptions for model-based valuation techniques. This hierarchy requires us to use observable market data, when available, and to minimize the use of unobservable inputs when determining fair value.

Money market funds are actively traded and consist of highly liquid investments with original maturities of 90 days or less. They are measured at their net asset value (NAV) and classified as Level 1. Corporate and agency bonds and commercial paper are categorized as Level 2 assets except where sufficient quoted prices exist in active markets, in which case such securities are categorized as Level 1 assets. These securities are valued using third-party pricing services. These services may use, for example, model-based pricing methods that utilize observable market data as inputs. We generally use quoted prices for recent trading activity of assets with similar characteristics to the debt security or bond being valued. The securities and bonds priced using such methods are generally classified as Level 2. Broker dealer bids or quotes on securities with similar characteristics may also be used.

The carrying amounts of cash and cash equivalents, accounts receivable, accounts payable and accrued liabilities approximate fair value due to the short-term nature of these assets and liabilities.

Contingent Consideration—We estimate and record at the acquisition date, the fair value of contingent consideration making up part of the purchase price consideration for acquisitions. Additionally, at each reporting period, we estimate the change in the fair value of contingent consideration and any change in fair value is recognized in the consolidated statements of operations. We estimate the fair value of contingent consideration by discounting the associated expected cash flows, using a probability-weighted, discounted cash flow model. The estimate of the fair value of contingent consideration requires subjective assumptions to be made regarding future operating results, discount rates and probabilities assigned to various potential operating result scenarios.

Share-Based Compensation—We account for all share-based compensation arrangements using the fair value method. We recognize compensation expense over the requisite service period of the award, which is generally the vesting period, using the straight-line method and providing that the minimum amount of compensation recorded is equal to the vested portion of the award. We record the expense in the consolidated statements of operations in the same manner in which the award recipients' salary costs are classified. For restricted stock awards with service conditions we use the closing stock price on the date of grant to estimate the fair value of the awards. We use the Black-Scholes option-pricing model to estimate the fair value of stock options with service and performance conditions, inclusive of assumptions for risk-free interest rates, dividends, expected terms and estimated volatility. We derive the risk-free interest rate assumption from the U.S. Treasury's rates for U.S. Treasury zero-coupon bonds with maturities similar to the expected term of the award being valued. We base the assumed dividend yield on its expectation of not paying dividends in the foreseeable future. We calculate the weighted-average expected term of the options using the simplified method, which is a method of applying a formula that uses the vesting term and the contractual term to compute the expected term of a stock option. The decision to use the simplified method is based on a lack of relevant historical data, due to our limited operating experience. In addition, due to our limited historical data, we incorporate the historical volatility of comparable companies with publicly available share prices to determine estimated volatility. The accounting for share-based compensation requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Share-based awards that are settled in cash are recorded as liabilities. The measurement of the liability and compensation cost for these awards is based on the fair value of the award, and is recorded in operating income over the award's vesting period. Changes in our payment obligation prior to the settlement date of a stock-based award are recorded as compensation cost in operating income in the period of the change. The final payment amount for such awards is established on the date of the exercise of the award by the employee.

Guarantees and Indemnification Obligations—We enter into agreements in the ordinary course of business with, among others, customers, distributors and original equipment manufacturers (OEM). Most of these agreements require us to indemnify the other party against third-party claims alleging that a Company product infringes a patent and/or copyright. Certain agreements in which we grant limited licenses to Company intellectual property require us to indemnify the other party against third-party claims alleging that the use of the licensed intellectual property infringes a third-party's intellectual property. Certain of these agreements require us to indemnify the other party against certain claims relating to property damage, personal injury or the acts or omissions, its employees, agents or representatives. In addition, from time to time, we have made certain guarantees in the form of warranties regarding the performance of Company products to customers.

We have agreements with certain vendors, creditors, lessors and service providers pursuant to which we have agreed to indemnify the other party for specified matters, such as acts and omissions, its employees, agents or representatives. We have procurement or license agreements with respect to technology used in our products and agreements in which we obtain rights to a product from an OEM. Under some of these agreements, we have agreed to indemnify the supplier for certain claims that may be brought against such party with respect to our acts or omissions relating to the supplied products or technologies.

Our certificate of incorporation and agreements with certain of our directors and officers and certain of our subsidiaries' directors and officers provide them indemnification rights, to the extent legally permissible, against liabilities incurred by them in connection with legal actions in which they may become involved by reason of their service as a director or officer. As a matter of practice, we have maintained director and officer liability insurance

coverage, including coverage for directors and officers of acquired companies.
We have not experienced any losses related to these indemnification obligations in any period presented and no claims with respect thereto were outstanding as of September 29, 2017 and September 30, 2016. We do not expect significant claims related to these indemnification obligations and, consequently, have concluded that the fair value of these obligations is negligible. No liabilities related to indemnification liabilities have been established.
Recent Accounting Pronouncements—In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-09, Revenue from Contracts with Customers, which supersedes all existing revenue recognition requirements, including most industry-specific guidance. The new standard requires a company to recognize revenue when it transfers goods or services to customers in an amount that reflects the consideration that the company expects to receive for those goods or services. In August 2015, the FASB issued ASU No. 2015-14, Revenue from Contracts with Customers: Deferral of the Effective Date, which delayed the effective date of the new standard from January 1, 2017 to January 1, 2018. The FASB also agreed to allow entities to choose to adopt the standard as of the original effective date. We are still in the process of completing our gap analysis on the impact of this guidance. At this time, with the consideration that we currently recognize distributor revenue based on sell-in accounting, we do not expect the adoption of Topic 606 to have a material impact on our financial position and results of operations. The standard permits the use of either the retrospective or cumulative effect transition method, and we are currently evaluating the method of adoption.

In August 2014, the FASB issued ASU 2014-15, Presentation of Financial Statements - Going Concern, which provides guidance on management's responsibility to assess whether there is substantial doubt about a company's ability to continue as a going concern. The guidance is effective for annual periods ending after December 15, 2016 and interim periods thereafter. As of September 29, 2017, we have adopted this guidance and performed the required assessment which did not have a significant impact on our consolidated financial statement disclosures.
In January 2016, the FASB issued ASU 2016-01, Recognition and Measurement of Financial Liabilities. This update makes amendments to the guidance in U.S. GAAP on the classification and measurement of financial instruments. The new standard significantly revises an entity's accounting related to (1) the classification and measurement of investments in equity securities and (2) the presentation of certain fair value changes for financial liabilities measured at fair value. It also amends certain disclosure requirements associated with the fair value of financial instruments. ASU 2016-01 is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. We are evaluating the effect that the updated standard will have on our consolidated financial statements and related disclosures.
In February 2016, the FASB issued ASU 2016-02, Leases, which increases transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. Certain qualitative and quantitative disclosures are required, as well as a retrospective recognition and measurement of impacted leases. The new guidance is effective for fiscal years and interim periods within those years beginning after December 15, 2018, with early adoption permitted. We are evaluating the effect that the updated standard will have on our consolidated financial statements and related disclosures and we anticipate that this new guidance will materially impact our financial statements as we have a significant number of operating leases.
In March 2016, the FASB issued ASU 2016-09, Improvements to Employee Share-Based Payment Accounting, which simplifies several aspects of the accounting for employee share-based payment transactions for both public and nonpublic entities, including the accounting for income taxes, forfeitures and statutory tax withholding requirements, as well as classification in the statement of cash flows. Early adoption is permitted and the updated standard must be adopted no later than our fiscal first quarter of fiscal year 2018. We are evaluating the effect that the updated standard will have on our consolidated financial statements and related disclosures.
In June 2016, the FASB issued ASU 2016-13, Measurement of Credit Losses on Financial Instruments. This update amends the guidance on reporting credit losses for assets held at amortized cost basis and available for sale debt securities. For available for sale debt securities, credit losses should be measured in a manner similar to current GAAP; however, this update will require that credit losses be presented as an allowance rather than as a write-down. ASU 2016-13 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. We are evaluating the effect that the updated standard will have on our consolidated financial statements and related disclosures.
In August 2016, the FASB issued ASU 2016-15, Classification of Certain Cash Receipts and Cash Payments. This update addresses debt prepayment or debt extinguishment costs, settlement of zero-coupon debt instruments or other debt instruments with coupon interest rates that are insignificant in relation to the effective interest rate of the borrowing, contingent consideration payments made after a business combination, proceeds from the settlement of insurance claims, proceeds from the settlement of corporate-owned life insurance policies, distributions received from equity method investees, beneficial interests in securitization transactions and separately identifiable cash flows and application of the predominance principle. ASU 2016-15 is effective for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. We are evaluating the effect that the updated standard will have on our consolidated financial statements and related disclosures.
In October 2016, the FASB issued ASU 2016-16, Intra-Entity Transfers of Assets Other Than Inventory. This update amends the guidance on recognizing the income tax consequences of an intra-entity transfer of an asset other than inventory when the transfer occurs. Consequently, the amendment eliminates the exception for an intra entity transfer of an asset other than inventory. ASU 2016-16 is effective for annual reporting periods beginning after December 15, 2017, including interim reporting periods within those annual reporting periods. We are evaluating the effect that the

updated standard will have on our consolidated financial statements and related disclosures.

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3. ACQUISITIONS

Acquisition of Applied Micro Circuits Corporation— On January 26, 2017, we completed the acquisition of Applied Micro Circuits Corporation (AppliedMicro), a global provider of silicon solutions for next-generation cloud infrastructure and Cloud Data Centers, as well as connectivity products for edge, metro and long-haul communications equipment (the AppliedMicro Acquisition). We acquired AppliedMicro in order to expand our business in enterprise and Cloud Data Center applications. In connection with the AppliedMicro Acquisition, we acquired all of the outstanding common stock of AppliedMicro for total consideration of $695.4 million, which included cash paid of $287.1 million, less $56.8 million of cash acquired, and equity issued at a fair value of $465.1 million. In conjunction with the equity issued, we granted vested out-of-the-money stock options and unvested restricted stock units to replace outstanding vested out-of-the-money stock options and unvested restricted stock units of AppliedMicro. The total fair value of granted vested out-of-money stock options and unvested restricted stock units was $14.5 million, of which $9.3 million was attributable to pre-combination service and was included in the total consideration transferred. We funded the AppliedMicro Acquisition with cash on hand and short term investments. For the fiscal year ended September 29, 2017, we recorded transaction costs of $11.9 million. We recorded transaction costs related to the acquisition in selling, general and administrative expense, except for $1.0 million related to equity issuance costs that were recorded to additional paid in capital. The AppliedMicro Acquisition was accounted for as a stock purchase and the operations of AppliedMicro have been included in our consolidated financial statements since the date of acquisition.

We recognized the AppliedMicro assets acquired and liabilities assumed based upon the fair value of such assets and liabilities measured as of the date of acquisition. The aggregate purchase price for AppliedMicro has been allocated to the tangible and identifiable intangible assets acquired and liabilities assumed based on their estimated fair value at the date of acquisition. The excess of the purchase price over the fair value of the acquired net assets represents cost and revenue synergies specific to the Company, as well as non-capitalizable intangible assets, such as the employee workforce acquired, and has been allocated to goodwill, none of which will be tax deductible.

The purchase accounting is preliminary and subject to completion including certain fair value measurements, particularly the finalization of the valuation assessment of the acquired tangible and intangible assets. The adjustments arising from the completion of the outstanding matters may materially affect the preliminary purchase accounting.

In connection with the acquisition of AppliedMicro, we announced a plan to divest a portion of AppliedMicro's business specifically related to its Compute business. Accordingly, these assets and liabilities are accounted for as discontinued operations and classified as assets and liabilities held for sale.

The following table summarizes the total estimated acquisition consideration (in thousands):

Cash consideration paid to AppliedMicro common stockholders	$287,060
Common stock issued (9,544,125 shares of our common stock at $47.53 per share)	453,632
Equity consideration for vested "in-the-money" stock options and unvested restricted stock units	2,143
Fair value of the replacement equity awards attributable to pre-acquisition service	9,307
Total consideration paid, less cash acquired	$752,142

The preliminary allocation of purchase price as of September 29, 2017 is as follows (in thousands):

	Preliminary Allocation March 31, 2017	Allocation Adjustments	Adjusted Allocation September 29, 2017
Current assets	$ 70,338	$ 96	$ 70,434
Intangible assets	410,348	2,500	412,848
Assets held for sale	32,458	8,486	40,944
Other assets	13,504	(3,704)	9,800
Total assets acquired	526,648	7,378	534,026
Liabilities held for sale	4,444	—	4,444
Other liabilities	17,890	(263)	17,627
Total liabilities assumed	22,334	(263)	22,071
Net assets acquired	504,314	7,641	511,955
Consideration:			
Cash paid upon closing	230,298	—	230,298
Common stock issued	455,775	—	455,775
Equity instruments issued	9,307	—	9,307
Total consideration	$ 695,380	$ —	$ 695,380
Goodwill	$ 191,066	$ (7,641)	$ 183,425

The components of the acquired intangible assets were as follows (in thousands):

	Included In Assets Held For Sale	Included In Retained Business	Useful Lives (Years)
Developed technology	$ 9,600	$ 78,448	7 years
Customer relationships	—	334,400	14 years
	$ 9,600	$ 412,848	

The overall weighted-average life of the identified intangible assets acquired in the AppliedMicro Acquisition is estimated to be 12.7 years and the assets are being amortized over their estimated useful lives based upon the pattern over which we expect to receive the economic benefit from these assets.

The following is a summary of AppliedMicro revenue and earnings included in our accompanying consolidated statements of operations for the fiscal year ended September 29, 2017 (in thousands):

	Amount
Revenue	$ 110,117
Loss from continuing operations	(27,222)
Loss from discontinued operations	(44,599)

The pro forma statements of operations data for the fiscal years ended September 29, 2017 and September 30, 2016, below, give effect to the AppliedMicro Acquisition, described above, as if it had occurred at October 2, 2015. These amounts have been calculated after applying our accounting policies and adjusting the results of AppliedMicro to reflect: transaction costs, retention compensation expense, the impact of the step-up to the value of acquired inventory, as well as the additional intangible amortization that would have been charged assuming the fair value adjustments had been applied and incurred since October 2, 2015. This pro forma data is presented for informational purposes only and does not purport to be indicative of our future results of operations.

	Fiscal Year Ended	
	September 29, 2017	September 30, 2016
Revenue	$755,728	$ 707,299
Loss from continuing operations	(104,828)	(53,613)
Loss from discontinued operations	(43,734)	(72,730)

Acquisition of Assets of Picometrix LLC— On August 9, 2017, we completed the acquisition of certain assets of Picometrix LLC (Picometrix), a supplier of optical-to-electrical converters for Cloud Data Center infrastructure (the Picometrix Acquisition). We acquired Picometrix in order to expand our business in enterprise and Cloud Data Center applications. The purchase consideration was $33.5 million, comprised of an upfront cash payment of $29.5 million, and $4.0 million placed in escrow for potential satisfaction of certain indemnification obligations that may arise from the closing date through December 15, 2018. For the fiscal year ended September 29, 2017, we recorded transaction costs of $0.2 million in selling, general and administrative expense. The Picometrix Acquisition was accounted for as an asset purchase, and the operations of Picometrix have been included in our consolidated financial statements since the date of acquisition.

We recognized the Picometrix assets acquired based upon the fair value of such assets measured as of the date of acquisition. The aggregate purchase price for the Picometrix assets has been allocated to the tangible and identifiable intangible assets acquired based on their estimated fair value at the date of acquisition. The excess of the purchase price over the fair value of the acquired assets represents cost and revenue synergies specific to the Company, as well as non-capitalizable intangible assets, such as the employee workforce acquired, and has been allocated to goodwill, all of which will be tax deductible.

The purchase accounting is preliminary and subject to completion including certain fair value measurements, particularly the finalization of the valuation assessment of the acquired tangible and intangible assets. The adjustments arising from the completion of the outstanding matters may materially affect the preliminary purchase accounting.

The preliminary allocation of purchase price as of September 29, 2017 is as follows (in thousands):

	Preliminary Allocation September 29, 2017
Current assets	$ 7,375
Intangible assets	19,000
Other assets	3,301
Total assets acquired	29,676
Current liabilities	2,169
Other liabilities	190
Total liabilities assumed	2,359
Net assets acquired	27,317
Consideration:	
Cash paid upon closing, net of cash acquired	33,500

Goodwill	$ 6,183

The pro forma financial information for fiscal year 2017, including revenue and net income, is immaterial, and has not been separately presented.

Other Acquisitions— On July 31, 2017, we completed the acquisition of certain assets of Antario Technologies, Inc. (Antario) a privately-held company based in Taiwan and in California. The total cash consideration was approximately $5.8 million, of which $4.8 million was paid upon closing, and approximately $1.0 million was withheld for potential satisfaction of certain indemnification

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obligations that may arise from the closing date through July 31, 2018. We have recorded a preliminary allocation of the purchase price for the assets of Antario, which resulted in goodwill of $1.6 million and intangible assets, including acquired technology and customer relationships, of $4.1 million. The Antario transaction was accounted for as an asset purchase and the operations have been included in our consolidated financial statements since the acquisition date. Pro forma financial disclosures are not presented herein as the financial results of Antario are considered immaterial.
On May 26, 2017, we completed the acquisition of Triple Play Communications Corporation (TPC) a privately-held company based in Melbourne, Florida. The total cash consideration was approximately $2.6 million, of which $2.2 million was paid upon closing, and approximately $0.4 million was withheld for potential satisfaction of certain indemnification obligations from the closing date through November 23, 2018. We have recorded a preliminary allocation of the purchase price for TPC, which resulted in goodwill of $3.9 million and intangible assets, including customer relationships, of $0.2 million. TPC was accounted for as a stock purchase and the operations have been included in our consolidated financial statements since the acquisition date. Pro forma financial disclosures are not presented herein as the financial results of TPC are considered immaterial.
Acquisition of FiBest Limited—On December 9, 2015, we completed the acquisition of FiBest Limited (FiBest) a Japan-based merchant market component supplier of optical sub-assemblies (FiBest Acquisition). We acquired FiBest to expand our position in optical networking components. In connection with the FiBest Acquisition, all of the outstanding equity interests (including outstanding options) of FiBest were exchanged for aggregate consideration of $59.1 million including cash of $47.5 million and assumed debt of $11.6 million. We funded the FiBest Acquisition with cash on hand. There were no transaction costs recorded for the fiscal year ended September 29, 2017. For the fiscal year ended September 30, 2016, we recorded transaction costs of $2.7 million as selling, general and administrative expense related to this acquisition.
The FiBest Acquisition was accounted for as a stock purchase and the operations of FiBest have been included in our consolidated financial statements since the date of acquisition.
We recognized the FiBest assets acquired and liabilities assumed based upon the fair value of such assets and liabilities measured as of the date of acquisition. The aggregate purchase price for FiBest is being allocated to the tangible and identifiable intangible assets acquired and liabilities assumed based on their estimated fair values at the date of acquisition. The excess of the purchase price over the fair value of the acquired net assets represents cost and revenue synergies specific to the Company, as well as non-capitalizable intangible assets, such as the employee workforce acquired, and has been allocated to goodwill, none of which will be tax deductible.
During the fiscal quarter ended December 30, 2016, we recorded an adjustment of $0.2 million primarily related to other liabilities and an adjustment of the deferred tax liability associated with the FiBest Acquisition. We finalized our allocation of purchase price during the fiscal quarter ended December 30, 2016. The final allocation of purchase price as of December 30, 2016, is as follows (in thousands):

	Preliminary Allocation as of September 30, 2016	Allocation Adjustments	Final Allocation
Current assets	$ 10,445	$ —	$ 10,445
Intangible assets	45,650	—	45,650
Other assets	3,317	—	3,317
Total assets acquired	59,412	—	59,412
Debt	11,627	—	11,627
Deferred income taxes	11,658	(106)	11,552
Other liabilities	3,968	326	4,294

Total liabilities assumed	27,253	220	27,473
Net assets acquired	32,159	(220)	31,939
Consideration:			
Cash paid upon closing, net of cash acquired	47,517	—	47,517
Goodwill	$ 15,358	$ 220	$ 15,578

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The components of the acquired intangible assets on a preliminary basis were as follows (in thousands):

	Amount	Useful Lives (Years)
Developed technology	$9,400	7
Customer relationships	36,250	10
	$45,650	

The overall weighted-average life of the identified intangible assets acquired in the FiBest Acquisition is estimated to be 9.4 years and the assets are being amortized over their estimated useful lives based upon the pattern over which we expect to receive the economic benefit from these assets.
The following is a summary of FiBest revenue and earnings included in our accompanying consolidated statements of operations for the fiscal year ended September 30, 2016 (in thousands):

	Amount
Revenue	$30,540
Loss before income taxes	(4,616)

Unaudited Supplemental Pro Forma Data—The pro forma statements of operations data for the fiscal year ended September 30, 2016 and October 2, 2015 below give effect to the FiBest Acquisition, described above, as if it had occurred at October 4, 2014. These amounts have been calculated after applying our accounting policies and adjusting the results of FiBest to reflect; transaction costs, retention compensation expense, the impact of the step-up to the value of acquired inventory, as well as the additional intangible amortization that would have been charged assuming the fair value adjustments had been applied and incurred since October 4, 2014. This pro forma data is presented for informational purposes only and does not purport to be indicative of our future results of operations.

	Fiscal Year Ended	
	September 30, 2016	October 2, 2015
Revenue	$551,964	$444,991
Net (loss) income	(3,324)	36,715

Acquisition of Aeroflex/Metelics Inc.—On December 14, 2015, we acquired Aeroflex/Metelics, Inc. (Metelics), a diode supplier for aggregate cash consideration of $37.1 million, subject to customary working capital and other adjustments (Metelics Acquisition). We acquired Metelics to expand our diode business. We funded the acquisition with cash on hand. The Metelics Acquisition was accounted for as a stock purchase and the operations of Metelics have been included in our consolidated financial statements since the date of acquisition. For the fiscal year ended September 29, 2017, we recorded no transaction costs related to this acquisition. For the fiscal year ended September 30, 2016, we recorded transaction costs of $0.5 million as selling, general and administrative expenses related to this acquisition.
We recognized the Metelics assets acquired and liabilities assumed based upon the fair value of such assets and liabilities measured as of the date of acquisition. The aggregate purchase price for Metelics is being allocated to the tangible and identifiable intangible assets acquired and liabilities assumed based on their estimated fair values at the date of acquisition. The excess of the purchase price over the fair value of the acquired net assets represents cost and revenue synergies specific to the Company, as well as non-capitalizable intangible assets, such as the employee workforce acquired, and has been allocated to goodwill, which will be tax deductible due to a 338(h)(10) election.

We finalized our allocation of purchase price during the fiscal quarter ended December 30, 2016. The final allocation of purchase price as of December 30, 2016, is as follows (in thousands):

	Preliminary Allocation as of September 30, 2016	Allocation Adjustments	Final Allocation
Current assets	$ 12,614	$ —	$ 12,614
Intangible assets	20,900	—	20,900
Other assets	3,089	—	3,089
Total assets acquired	36,603	—	36,603
Other liabilities	7,201	—	7,201
Total liabilities assumed	7,201	—	7,201
Net assets acquired	29,402	—	29,402
Consideration:			
Cash paid upon closing, net of cash acquired	37,125	—	37,125
Goodwill	$ 7,723	$ —	$ 7,723

The components of the acquired intangible assets on a preliminary basis were as follows (in thousands):

	Amount	Useful Lives (Years)
Developed technology	$1,000	7
Customer relationships	19,900	10
	$20,900	

The overall weighted-average life of the identified intangible assets acquired in the Metelics Acquisition is estimated to be 9.9 years and the assets are being amortized over their estimated useful lives based upon the pattern over which we expect to receive the economic benefit from these assets.

The following is a summary of Metelics revenue and earnings included in our accompanying consolidated statements of operations for the fiscal year ended September 30, 2016 (in thousands):

	Amount
Revenue	$33,552
Income before income taxes	3,372

Unaudited Supplemental Pro Forma Data—The pro forma statements of operations data for the fiscal year ended September 30, 2016 and October 2, 2015, below, give effect to the Metelics Acquisition, described above, as if it had occurred at October 4, 2014. These amounts have been calculated after applying our accounting policies and adjusting the results of Metelics to reflect the transaction costs, the impact of the step-up to the value of acquired inventory, as well as, the additional intangible amortization that would have been charged assuming the fair value adjustments had been applied and incurred since October 4, 2014. This pro forma data is presented for informational purposes only and does not purport to be indicative of our future results of operations.

	Fiscal Year Ended	
	September 30, 2016	October 2, 2015
Revenue	$553,174	$459,048
Net income	1,183	45,107

Acquisition of BinOptics Corporation—On December 15, 2014, we completed the acquisition of BinOptics Corporation (BinOptics), a supplier of high-performance photonic semiconductor products (BinOptics Acquisition). In accordance with the related Agreement and Plan of Merger, all of the outstanding equity interests (including outstanding warrants)

of BinOptics were exchanged for aggregate consideration of approximately $208.4 million in cash. In addition we paid $14.6 million as part of a related retention

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escrow agreement designed to retain certain BinOptics employees. This $14.6 million was included in the terms of the purchase agreement and has been accounted for as a post-closing prepaid expense. We funded the BinOptics Acquisition with a combination of cash on hand and the incurrence of $100.0 million of additional borrowings under our existing Revolving Facility. For the fiscal year ended October 2, 2015, we recorded transaction costs of approximately $4.2 million related to the BinOptics Acquisition in selling, general and administrative expense in the accompanying consolidated statements of operations.
The BinOptics Acquisition was accounted for as a purchase and the operations of BinOptics have been included in our consolidated financial statements since the date of acquisition.
We have recognized BinOptics' assets acquired and liabilities assumed based upon the fair value of such assets and liabilities measured as of the date of acquisition. The aggregate purchase price for BinOptics has been allocated to the tangible and identifiable intangible assets acquired and liabilities assumed based on their estimated fair values at the date of acquisition. The excess of the purchase price over the fair value of the acquired net assets represents cost and revenue synergies specific to the Company, as well as non-capitalizable intangible assets, such as the employee workforce acquired, and has been allocated to goodwill, none of which is tax deductible.
We finalized our allocation of purchase price during the first quarter of fiscal year 2016. The final allocation of purchase price as of January 1, 2016, was as follows (in thousands):

	Preliminary Allocation as of October 2, 2015	Allocation Adjustments	Final Allocation
Current assets	$ 23,674	$ (1,100)	$ 22,574
Intangible assets	136,900	400	137,300
Other assets	9,194	—	9,194
Total assets acquired	169,768	(700)	169,068
Debt	2,535	—	2,535
Deferred income taxes	33,345	99	33,444
Other liabilities	13,106	—	13,106
Total liabilities assumed	48,986	99	49,085
Net assets acquired	120,782	(799)	119,983
Consideration:			
Cash paid upon closing, net of cash acquired	208,352	—	208,352
Goodwill	$ 87,570	$ 799	$ 88,369

The components of the acquired intangible assets were as follows (in thousands):

	Amount	Useful Lives (Years)
Developed technology	$17,500	7
Customer relationships	119,800	10
	$137,300	

The overall weighted-average life of the identified intangible assets acquired in the BinOptics Acquisition is estimated to be 9.6 years and the assets are being amortized over their estimated useful lives based upon the pattern over which we expect to receive the economic benefit from these assets.
The following is a summary of BinOptics revenue and earnings included in our consolidated statements of operations for the fiscal year ended October 2, 2015 (in thousands):

	Fiscal Year Ended

	October 2, 2015
Revenue	$61,549
Income before income taxes	354

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Unaudited Supplemental Pro Forma Data—The pro forma statements of operations data for the fiscal year ended October 2, 2015, below, give effect to the BinOptics Acquisition, described above, as if it had occurred at September 28, 2013. These amounts have been calculated after applying our accounting policies and adjusting the results of BinOptics to reflect the additional depreciation and amortization that would have been charged assuming the fair value adjustments to property, plant and equipment and intangible assets and additional interest expense on acquisition-related borrowings had been applied and incurred since September 28, 2013. This pro forma data is presented for informational purposes only and does not purport to be indicative of our future results of operations.

	October 2, 2015
Revenue	$428,440
Net income from continuing operations	(3,489)

4. INVESTMENTS

All investments are short term in nature and are invested in corporate bonds, commercial paper and agency bonds, and are classified as available-for-sale. The amortized cost, gross unrealized holding gains or losses and fair value of our available-for-sale investments by major investments type as of September 29, 2017 and September 30, 2016 are summarized in the tables below (in thousands):

	September 29, 2017			
	Amortized Cost	Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	Aggregate Fair Value
Corporate bonds	$26,366	$ 10	$ (166)	$26,210
Commercial paper	57,943	4	(36)	57,911
Total investments	$84,309	$ 14	$ (202)	$84,121

	September 30, 2016			
	Amortized Cost	Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	Aggregate Fair Value
Corporate bonds	$14,894	$ 9	$ (104)	$14,799
Commercial paper	2,978	—	(3)	2,975
Agency bonds	6,004	1	(3)	6,002
Total investments	$23,876	$ 10	$ (110)	$23,776

The contractual maturities of available-for-sale investments were as follows (in thousands):

	September 29, 2017
Less than 1 year	$ 60,433
Over 1 year	23,688
Total investments	$ 84,121

Available-for-sale investments are reported at fair value and as such, their associated unrealized gains and losses are reported as a separate component of stockholders' equity within accumulated other comprehensive income (loss). We have determined that the gross unrealized losses on available for sale securities at September 29, 2017 and September 30, 2016 are temporary in nature. We review our investments to identify and evaluate investments that have indications of possible impairment. The techniques used to measure the fair value of our investments are described in Note 5 - Fair Value. Factors considered in determining whether a loss is temporary include the length of time and extent to which fair value has been less than the cost basis, the financial condition and near-term prospects of the investee, and our intent and ability to hold the investment for a period of time sufficient to allow for any anticipated recovery in market value. Substantially all of our fixed income securities are rated investment grade or

better.

We received proceeds from sales of available-for-sale securities of $44.6 million during the fiscal year ended September 29, 2017. During the fiscal year ended September 30, 2016 we received proceeds from sales of available-for-sale securities of $51.6 million. Such sales resulted in the recording of gross realized gains of zero and $0.1 million and gross realized losses of $0.1 million and $0.2 million during the fiscal years ended September 29, 2017 and September 30, 2016, respectively, which have been recorded within other (expense) income.

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5. FAIR VALUE

We group our financial assets and liabilities measured at fair value on a recurring basis in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value. These levels are:

Level 1 - Quoted prices in active markets for identical assets or liabilities.

Level 2 - Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities, quoted prices in markets with insufficient volume or infrequent transactions (less active markets) or model-driven valuations in which all significant inputs are observable or can be derived principally from, or corroborated with, observable market data.

Level 3 - Fair value is derived from valuation techniques in which one or more significant inputs are unobservable, including assumptions and judgments made by us.

Assets and Liabilities Measured and Recorded at Fair Value on a Recurring Basis

We measure certain assets and liabilities at fair value on a recurring basis such as our financial instruments and derivatives. There have been no transfers between Level 1, 2 or 3 assets or liabilities during the fiscal year ended September 29, 2017.

Assets and liabilities measured at fair value on a recurring basis consist of the following (in thousands):

	September 29, 2017			
	Fair Value	Active Markets for Identical Assets (Level 1)	Observable Inputs (Level 2)	Unobservable Inputs (Level 3)
Assets				
Money market funds	$36	$ 36	$ —	$ —
Commercial paper	57,911	—	57,911	—
Corporate bonds	26,210	—	26,210	—
Total assets measured at fair value	$84,157	$ 36	$ 84,121	$ —
Liabilities				
Contingent consideration	$1,679	$ —	$ —	$ 1,679
Common stock warrant liability	40,775	—	—	40,775
Total liabilities measured at fair value	$42,454	$ —	$ —	$ 42,454

	September 30, 2016			
	Fair Value	Active Markets for Identical Assets (Level 1)	Observable Inputs (Level 2)	Unobservable Inputs (Level 3)
Assets				
Money market funds	$1,172	$ 1,172	$ —	$ —
Commercial paper	102,928	—	102,928	—
US treasuries and agency bonds	6,002	—	6,002	—
Corporate bonds	14,799	—	14,799	—
Total assets measured at fair value	$124,901	$ 1,172	$ 123,729	$ —
Liabilities				

Contingent consideration	$848	$ —	$ —	$ 848
Warrant liability	38,253	—	—	38,253
Total liabilities measured at fair value	$39,101	$ —	$ —	$ 39,101

The quantitative information utilized in the fair value calculation of our Level 3 liabilities are as follows:

Liabilities	Valuation Technique	Unobservable Input	September 29, 2017	September 30, 2016
Contingent consideration	Discounted cash flow	Discount rate	9.2%	12.9%
		Probability of achievement	70% - 100%	75% - 100%
		Timing of cash flows	2 - 8 months	1 year
Warrant liability	Black-scholes model	Volatility	44.9%	43.2%
		Discount rate	1.62%	1.14%
		Expected life	3.2 years	4.2 years
		Exercise price	$14.05	$14.05
		Stock price	$44.61	$42.34
		Dividend rate	—%	—%

The fair values of the contingent consideration liabilities were estimated based upon a risk-adjusted present value of the probability-weighted expected payments by us. Specifically, we considered base, upside and downside scenarios for the operating metrics upon which the contingent payments are to be based. Probabilities were assigned to each scenario and the probability-weighted payments were discounted to present value using risk-adjusted discount rates.

The changes in assets and liabilities with inputs classified within Level 3 of the fair value hierarchy consist of the following (in thousands):

	Fiscal Year 2017					
	September 30, 2016	Net Realized/Unrealized Losses (Gains) Included in Earnings	Purchases and Issuances	Sales and Settlements	Transfers in and/or (out) of Level 3	September 29, 2017
Contingent consideration	$848	$ 180	$ 1,701	$ (1,050)	$ —	$ 1,679
Warrant liability	$38,253	$ 2,522	$ —	$ —	$ —	$ 40,775

	Fiscal Year 2016					
	October 2, 2015	Net Realized/Unrealized Losses (Gains) Included in Earnings	Purchases and Issuances	Sales and Settlements	Transfers in and/or (out) of Level 3	September 30, 2016
Contingent consideration	$1,150	$ 98	$ —	$ (400)	$ —	$ 848
Warrant liability	$21,822	$ 16,431	$ —	$ —	$ —	$ 38,253

	Fiscal Year 2015					
	October 3, 2014	Net Realized/Unrealized Losses (Gains) Included in Earnings	Purchases and Issuances	Sales and Settlements	Transfers in and/or (out) of Level 3	October 2, 2015
Trading securities	$250	$ —	$ 500	$ (750)	$ —	$ —
Contingent consideration	$820	$ 330	$ —	$ —	$ —	$ 1,150
Warrant liability	$15,802	$ 6,020	$ —	$ —	$ —	$ 21,822

6. ACCOUNTS RECEIVABLES ALLOWANCES

Summarized below is the activity in our accounts receivable allowances including customer returns, doubtful accounts and other items as follows (in thousands):

	Fiscal Year		
	2017	2016	2015
Balance - beginning of year	$3,279	$5,745	$725
Provision, net	29,512	10,453	11,010
Charge-offs	(23,381)	(12,919)	(5,990)
Balance - end of year	$9,410	$3,279	$5,745

The balances at the end of fiscal years 2017, 2016 and 2015 primarily include compensation credits and customer returns allowances of $8.9 million, $3.0 million and $5.5 million, respectively, and allowances for doubtful accounts of $0.3 million for fiscal year 2017 and $0.2 million for fiscal years 2016 and 2015.

7. INVENTORIES

Inventories consist of the following (in thousands):

	September 29, 2017	September 30, 2016
Raw materials	$ 78,999	$ 67,378
Work-in-process	13,962	9,157
Finished goods	43,113	38,400
Total	$ 136,074	$ 114,935

8. PROPERTY, PLANT AND EQUIPMENT

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

	September 29, 2017	September 30, 2016
Land, buildings and improvements	$ —	$ 12,572
Construction in process	22,195	9,415
Machinery and equipment	160,955	126,432
Leasehold improvements	13,809	12,152
Furniture and fixtures	2,078	1,469
Capital lease assets	20,410	3,207
Computer equipment and software	16,539	12,954
Total property and equipment	235,986	178,201
Less accumulated depreciation and amortization	(104,967)	(79,034)
Property and equipment — net	$ 131,019	$ 99,167

In fiscal year 2017 capital lease assets includes $16.9 million of assets related to our corporate facility lease obligation, with the remaining balance primarily related to leased equipment. In fiscal year 2016 the capital lease assets are primarily related to leased equipment. Depreciation and amortization expense related to property and equipment for fiscal years 2017, 2016 and 2015 was $27.3 million, $20.4 million and $15.7 million, respectively.

9. DEBT

As of September 29, 2017, we had $686.7 million of outstanding Term Loan borrowings under the Credit Agreement and $160.0 million of borrowing capacity under our Revolving Facility. The history of our Term Loans, Credit Agreement and Revolving Facility are further discussed below.

On May 8, 2014, we entered into a credit agreement (Credit Agreement) with a syndicate of lenders that provided for term loans in an aggregate principal amount of $350.0 million, which were scheduled to mature in May 2021 (Initial Term Loans) and a revolving credit facility of $100.0 million initially (as increased by the amendments described below, Revolving Facility). In February 2015, we executed an amendment to the Credit Agreement that increased our

aggregate borrowing capacity under the Revolving Facility to $130 million. The Initial Term Loans were issued with an original issue discount of 0.75%, which is being amortized over the term of the Initial Term Loans using the straight-line method, which approximates the effective interest rate method.

On August 31, 2016, we entered into an amendment (2016 Incremental Term Loan Amendment) to our Credit Agreement which provided for incremental term loans in an aggregate principal amount of $250.0 million, which were scheduled to mature in May 2021 (2016 Incremental Term Loans). The terms of the 2016 Incremental Term Loans were identical to the terms of the Initial Term Loans, other than with respect to upfront fees, original issue discount and arrangement, structuring or similar fees payable in connection therewith. The 2016 Incremental Term Loans were issued with an original issue discount of 0.95%, which is being amortized over the term of the 2016 Incremental Term Loans using the straight-line method, which approximates the effective interest rate method.

On March 10, 2017, we entered into multiple amendments to our Credit Agreement (the March 2017 Amendments), which consisted of (i) the Second Incremental Amendment, by and among MACOM, Barclays Bank PLC and Goldman Sachs Bank USA, as administrative agent, (ii) the Refinancing Amendment, by and among MACOM, the lenders party thereto and Goldman Sachs Bank USA, as administrative agent and (iii) Amendment No. 4 to the Credit Agreement, by and among MACOM, the revolving credit lenders and Goldman Sachs Bank USA, as administrative agent. Pursuant to the March 2017 Amendments, we increased the revolving credit commitments available under our revolving credit facility by $30.0 million to $160.0 million. No amounts were drawn under the Revolving Facility on the closing date of the March 2017 Amendments or as of September 29, 2017. In addition, pursuant to the March 2017 Amendments, our existing term loans were refinanced at a reduced interest rate.

Further, pursuant to the March 2017 Amendments, the Credit Agreement was amended to provide that the financial covenant under the Revolving Facility would only be tested if, as of the last date of any fiscal quarter, the aggregate amount outstanding under the Revolving Facility (other than with respect to (a) undrawn letters of credit in an amount not to exceed $5.0 million and (b) letters of credit that have been cash collateralized pursuant to the Credit Agreement) exceeds 35% of the revolving credit commitments under the Revolving Facility. Prior to the March 2017 Amendments, the threshold for testing the financial covenant was set at 25% of the revolving credit commitments under the Revolving Facility.

On May 19, 2017, we entered into two amendments to our Credit Agreement (the May 2017 Amendments) which consisted of (i) the Second Refinancing Amendment, among MACOM, Morgan Stanley Senior Funding, Inc. and the other term lenders party thereto and Goldman Sachs Bank USA, as administrative agent (the Second Refinancing Amendment), and (ii) the Second Incremental Term Loan Amendment, among MACOM, Morgan Stanley Senior Funding, Inc. and the other lenders party thereto and Goldman Sachs Bank USA, as administrative agent (the Second Incremental Term Loan Amendment).

Pursuant to the Second Refinancing Amendment, our then existing term loans of $588.5 million were refinanced with a new tranche of term loans. The refinanced term loans will mature in May 2024 and bear interest at: (i) for LIBOR loans for any interest period, a rate per annum equal to the LIBOR rate as determined by the administrative agent, plus an applicable margin of 2.25%; and (ii) for base rate loans, a rate per annum equal to the greater of (a) the prime rate quoted in the print edition of the Wall Street Journal, Money Rates Section, (b) the federal funds rate plus one-half of 1.00% and (c) the LIBOR rate applicable to a one-month interest period plus 1.00% (but, in each case, not less than 1.00%), plus an applicable margin of 1.25%. The effective interest rate on our term loans was 3.5% as of September 29, 2017.

Pursuant to the Second Incremental Term Loan Amendment, we borrowed an additional $100.0 million of incremental term loans (the 2017 Incremental Term Loans, together with the Initial Term Loans and the 2016 Incremental Term Loans, Term Loans) on the same terms as the new tranche of term loans incurred pursuant to the Second Refinancing Amendment. The 2017 Incremental Term Loans and the new tranche of term B loans were issued with an original issue discount of 0.50%, which is being amortized over the term of the existing Term Loans using the straight-line method, which approximates the effective interest rate method.

We incurred $8.7 million in fees for the issuance of the Credit Agreement in May 2014, and $3.2 million in fees for the issuance of the 2016 Incremental Term Loan Amendment in August 2016, which were initially recorded as deferred financing costs and are being amortized over the life of the related Term Loans as interest expense. In March 2017, we incurred an additional $1.0 million in fees for the issuance of the March 2017 Amendments, and in May 2017, we incurred an additional $11.1 million in fees for the issuance of the May 2017 Amendments. In connection

with the March 2017 Amendments and the May 2017 Amendments, we determined that $0.9 million and $1.1 million of deferred costs previously capitalized should be expensed during our second and third fiscal quarters, respectively, as a loss on extinguishment of debt related to syndicated lenders whose debt was extinguished. As of September 29, 2017, approximately $13.7 million of deferred financing costs remain unamortized, of which $12.5 million related to the 2017 Incremental Term Loans is recorded as a direct reduction of the recognized debt liabilities in our accompanying consolidated balance sheet, and $1.2 million related to the Revolving Facility is recorded in other assets in our accompanying consolidated balance sheet.

The Term Loans are secured by a first priority lien on substantially all of our assets and provide that we must comply with certain financial and non-financial covenants.

The combined Term Loans are payable in quarterly principal installments of approximately $1.7 million on the last business day of each calendar quarter, with the remainder due on the maturity date. In the event that we divest a business, the net cash proceeds of the divestment are generally required, subject to certain exceptions, to be applied to repayment of outstanding Term Loans except to the extent we reinvest such proceeds in assets useful for our business within 18 months of receiving the proceeds. If we enter into

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a binding agreement to reinvest such proceeds within 18 months of receiving them, we have until the later of 18 months following our receipt of the proceeds and 6 months following the date of such agreement to complete the reinvestment.

As of September 29, 2017, the following remained outstanding on the Term Loans:

Principal balance	$686,741
Unamortized discount	(5,835)
Total term loans	680,906
Current portion	6,885
Long-term, less current portion	$674,021

As of September 29, 2017, the minimum principal payments under the Term Loans in future fiscal years were as follows (in thousands):

2018	$6,885
2019	6,885
2020	6,885
2021	6,885
2022	6,885
Thereafter	652,316
Total	$686,741

The fair value of the Term Loans was estimated to be approximately $696.2 million as of September 29, 2017 and was determined using Level 2 inputs, including a quoted rate from a bank.

10. CAPITAL LEASE AND FINANCING OBLIGATIONS

Corporate Facility Financing Obligation

On May 26, 2016, we entered into a Purchase and Sale Agreement (Purchase Agreement) with Calare Properties, Inc., a Delaware corporation (together with its affiliates, the Buyer), for the sale and subsequent leaseback of our corporate headquarters, located at 100 Chelmsford Street, Lowell, Massachusetts. The transactions contemplated by the Purchase Agreement closed on December 28, 2016, at which time we also entered into three lease agreements with the Buyer including: (1) a 20-year leaseback of the facility located at 100 Chelmsford Street (the 100 Chelmsford Lease), (2) a 20-year build-to-suit lease arrangement for the construction and subsequent lease back of a new facility to be located at 144 Chelmsford Street (the 144 Chelmsford Lease), and (3) a 14-year building lease renewal of an adjacent facility at 121 Hale Street (the 121 Hale Lease, and together with the 100 Chelmsford Lease and the 144 Chelmsford Lease, the Leases).

Because the transactions contemplated by the Purchase Agreement and the related Leases were negotiated and consummated at the same time and in contemplation of one another to achieve the same commercial objective, the transactions are accounted for by us as a single unit of accounting. In addition, the Leases were determined to represent a failed sale-leaseback due to our continuing involvement in the properties in the form of non-recourse financing. As a result, the Leases are accounted for under the financing method and we will be the deemed accounting owner under the arrangement, including the assets to be constructed under the 144 Chelmsford Lease. We will continue to recognize the existing building and improvements sold under the Purchase Agreement, capitalize the 121 Hale Street building as well as the assets constructed under the Leases, and depreciate the assets over the shorter of their estimated useful lives or the lease terms. The sale proceeds from the Purchase Agreement of $8.2 million (which includes $4.2 million in cash and $4.0 million in construction allowances) and the fair value of the 121 Hale Street building of $4.0 million were recognized as a financing obligation on our balance sheet and are being amortized over the 20-year lease term based on the minimum lease payments required under the Leases and our incremental borrowing rate. Future construction costs funded by the Buyer under the 144 Chelmsford Lease will be recognized as additional financing obligations on our balance sheet as incurred, and will be amortized over the 20-year lease term based on the minimum lease payments required under the Leases and our incremental borrowing rate. As of September 29, 2017, we have recorded $3.6 million of construction costs as additional financing obligations within

long-term debt in our accompanying consolidated financial statements.

As a result of the failed sale-leaseback accounting, we calculated a financing obligation as of the December 28, 2016 inception of the lease based on the future minimum lease payments discounted at 8.5%. The discount rate represents the estimated incremental borrowing rate over the lease term of 20 years. The minimum lease payments are recorded as interest expense and in part as a payment of principal reducing the financing obligation. The real property assets in the transaction remain on the consolidated balance sheets and continue to be depreciated over their remaining useful lives. As of September 29, 2017, approximately $15.8 million of the financing

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obligation was outstanding associated with the Leases, of which $3.6 million was associated with the 144 Chelmsford Lease that has not yet been placed in service.

Acquired Capital Leases

In connection with the FiBest Acquisition in December 2015 and the BinOptics Acquisition in December 2014 we assumed certain capital lease obligations, of which approximately $2.3 million was outstanding as of September 29, 2017.

Future Minimum Payments Under Capital lease Obligations

As of September 29, 2017, future minimum payments under capital lease obligations and financing obligations related to the Leases were as follows (in thousands):

Fiscal year ending:	Amount
2018	$1,895
2019	1,791
2020	1,619
2021	1,485
2022	1,276
Thereafter	19,264
Total minimum capital lease payments	$27,330
Less amount representing interest	$(14,698)
Present value of net minimum capital lease payments	$12,632

11. EMPLOYEE BENEFIT PLANS

We established a defined contribution savings plan under Section 401(k) of the Internal Revenue Code of 1986, as amended (Section 401(k)) on October 1, 2009 (401(k) Plan). The 401(k) Plan follows a calendar year, covers substantially all U.S. employees who meet minimum age and service requirements and allows participants to defer a portion of their annual compensation on a pretax basis, subject to legal limitations. Our contributions to the plan may be made at the discretion of the board of directors. During the fiscal year ended September 29, 2017, we contributed $2.4 million to our 401(k) Plan for calendar year 2016. There were no contributions made by us to the 401(k) Plan for calendar year 2017 through September 29, 2017.

Our employees located in foreign jurisdictions meeting minimum age and service requirements participate in defined contribution plans whereby participants may defer a portion of their annual compensation on a pretax basis, subject to legal limitations. Company contributions to these plans are discretionary and vary per region. We expensed contributions of $1.3 million, $1.1 million and $1.0 million for fiscal years 2017, 2016 and 2015, respectively.

12. ACCRUED LIABILITIES

Accrued liabilities consist of the following (in thousands):

	September 29, 2017	September 30, 2016
Compensation and benefits	$ 32,505	$ 32,563
Distribution costs	5,777	3,584
Income taxes payable	4,184	—
Product warranty	3,672	1,039
Professional fees	2,140	1,706
Deferred revenue	1,994	340
Contingent consideration	1,679	848
Rent and utilities	1,257	1,310
Purchase price holdback	1,000	—
Asset retirement obligations	959	2,932
Restructuring costs	627	3,104

Interest payable	532	4,314
Other	3,911	2,628
Total	$ 60,237	$ 54,368

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13. COMMITMENTS AND CONTINGENCIES

Operating Leases—We have non-cancelable operating lease agreements for office, research and development and manufacturing space in the United States and foreign locations. We also have operating leases for certain equipment, automobiles and services in the United States and foreign jurisdictions. These lease agreements expire at various dates through 2026, and certain agreements contain provisions for extension at substantially the same terms as currently in effect. Lease escalation clauses, rent abatements and/or concessions, such as rent holidays and landlord or tenant incentives or allowances, are typically included in the determination of straight-line rent expense over the lease term. Future minimum lease payments for the next five fiscal years as of September 29, 2017, are as follows (in thousands):

2018	$11,116
2019	9,001
2020	5,985
2021	3,828
2022	3,113
Thereafter	7,999
Total minimum lease payments	$41,042

Rent expense incurred under non-cancelable operating leases was $10.9 million, $7.0 million and $6.5 million in fiscal years 2017, 2016 and 2015, respectively.

Asset Retirement Obligations—We are obligated under certain facility leases to restore those facilities to the condition in which we or our predecessors first occupied the facilities. We are required to remove leasehold improvements and equipment installed in these facilities prior to termination of the leases. As of the end of fiscal years 2017, 2016 and 2015, the estimated costs for the removal of these assets are recorded as asset retirement obligations was $2.3 million, $4.3 million and $1.3 million, respectively.

Unused Letter of Credit—As of September 29, 2017, we had outstanding unused letters of credit from a bank aggregating $0.4 million.

Purchase Commitments—As of September 29, 2017, we had outstanding non-cancelable purchase commitments aggregating to $1.8 million pursuant to inventory supply arrangements.

Litigation—From time to time we may be subject to commercial disputes, employment issues, claims by other companies in the industry that we have infringed their intellectual property rights and other similar claims and litigations. Any such claims may lead to future litigation and material damages and defense costs. Other than as set forth below, we were not involved in any material pending legal proceedings during the year ended September 29, 2017.

GaN Lawsuit Against Infineon— On April 26, 2016, we and our wholly-owned subsidiary Nitronex, LLC brought suit against Infineon Technologies Americas Corporation (Infineon Americas) and Infineon Technologies AG (Infineon AG and collectively, with Infineon Americas, Infineon) in the Federal District Court for the Central District of California, seeking injunctive relief, monetary damages, and specific performance of certain contractual obligations. On July 19, 2016, we filed a first amended complaint, and, on November 21, 2016, we filed a second amended complaint. After motions to dismiss certain claims from MACOM's second amended complaint were denied on February 28, 2017, Infineon AG answered on March 24, 2017, asserting no counterclaims. Infineon Americas also answered and counterclaimed on March 24, 2017 and then submitted amended counterclaims on April 14, 2017. The court dismissed one of the counterclaims on June 5, 2017, and Infineon filed further amended counterclaims on June 19, 2017. MACOM answered the counterclaims on August 16, 2017.

The suit arises out of agreements relating to GaN patents that were executed in 2010 by Nitronex Corporation (acquired by us in 2014) and International Rectifier Corporation (International Rectifier) (acquired by Infineon AG in 2015). We assert claims for breach of contract, breach of the covenant of good faith and fair dealing, declaratory judgment of contractual rights, declaratory judgment of non-infringement of patents, and, against Infineon AG only, intentional interference with contract. If successful, the relief sought in our second amended complaint would, among

other remedies, require Infineon to assign back to us certain GaN-related Nitronex patents that were previously assigned to International Rectifier and enjoin Infineon from proceeding with its marketing and sales of certain types of GaN-on-Si products. In an order dated October 31, 2016, the Court granted us a preliminary injunction against Infineon, which then issued on December 7, 2016 and was modified on March 6, 2017. The preliminary injunction declares that an exclusive licensing arrangement between us and Infineon that Infineon had purported to terminate is still in effect and prohibits Infineon Americas and others acting in concert with it from engaging in certain activities in our exclusive field, which includes RF power amplifiers for cellular base stations. Infineon appealed the preliminary injunction order to the Federal Circuit on January 3, 2017, and MACOM appealed the modification order on April 5, 2017. The appeals are fully briefed and were argued together on September 6, 2017, with a decision expected in the next few months. Meanwhile, the district court case is proceeding, with trial set to begin on February 26, 2019.

With respect to the above legal proceeding, we have not been able to reasonably estimate the amount or range of any possible loss, and accordingly have not accrued or disclosed any related amounts of possible loss in the accompanying consolidated financial statements.

14. RESTRUCTURINGS

We have periodically implemented restructuring actions in connection with broader plans to reduce staffing, reduce our internal manufacturing footprint and, generally, reduce operating costs. The restructuring expenses are primarily comprised of direct and incremental costs related to headcount reductions including severance and outplacement fees for the terminated employees, as well as facility closure costs.

The following is a summary of the costs incurred and remaining balances included in accrued expenses related to restructuring actions taken (in thousands):

	Total
Balance - October 3, 2014	$801
Current period charges	1,280
Payments	(1,138)
Balance - October 2, 2015	943
Current period charges	3,465
Payments	(1,304)
Balance - September 30, 2016	3,104
Current period charges	2,744
Payments	(5,221)
Balance at September 29, 2017	$627

The restructuring expenses recorded to date are expected to be paid through the remainder of calendar year 2017. We expect to incur additional restructuring costs in the range of approximately $3.6 million and $4.5 million during our fiscal year 2018 as we complete restructuring actions primarily associated with facility consolidations.

15. PRODUCT WARRANTIES

We establish a product warranty liability at the time of revenue recognition. Product warranties generally have terms of 12 months and cover nonconformance with specifications and defects in material or workmanship. For sales to distributors, our warranty generally begins when the product is resold by the distributor. The liability is based on estimated costs to fulfill customer product warranty obligations and utilizes historical product failure rates. Should actual warranty obligations differ from estimates, revisions to the warranty liability may be required.

Product warranty liability activity is as follows (in thousands):

		Fiscal Years	
	2017	2016	2015
Balance — beginning of year	$1,039	$656	$446
Acquired	952	413	50
Provisions	1,737	(30)	160
Direct charges	(56)	—	—
Balance — end of year	$3,672	$1,039	$656

16. INTANGIBLE ASSETS

Amortization expense related to intangible assets is as follows (in thousands):

	Fiscal Years		
	2017	2016	2015
Cost of revenue	$30,286	$26,615	$27,285
Selling, general and administrative	35,456	23,640	11,695
Total	$65,742	$50,255	$38,980

Intangible assets consist of the following (in thousands):

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	September 29, 2017	September 30, 2016
Acquired technology	$ 251,655	$ 165,397
Customer relationships	556,648	207,674
In-process research and development	—	8,000
Trade name	3,400	3,400
Total	811,703	384,471
Less accumulated amortization	(190,611)	(124,869)
Intangible assets — net	$ 621,092	$ 259,602

A summary of the activity in intangible assets and goodwill follows (in thousands):

	Intangible Assets					
	Total	Acquired Technology	Customer Relationships	In-Process Research and Development	Trade Name	Goodwill
Balance at October 2, 2015	$318,006	$162,536	$ 144,070	$ 8,000	$3,400	$93,346
Acquired	65,350	10,400	54,950	—	—	20,412
Fair value adjustment	1,678	78	1,600	—	—	3,475
Currency translation adjustments	8,857	1,803	7,054	—	—	2,791
Impairments of intangible assets	(10,088)	(10,088)	—	—	—	—
Other intangibles purchased	668	668	—	—	—	—
Balance at September 30, 2016	384,471	165,397	207,674	8,000	3,400	120,024
Acquired	436,181	83,518	352,663	—	—	195,145
Placed in service	—	3,648	—	(3,648)	—	—
Fair value adjustment	—	—	—	—	—	220
Currency translation adjustments	(4,597)	(908)	(3,689)	—	—	(1,624)
Impairments of intangible assets	(4,352)	—	—	(4,352)	—	—
Balance at September 29, 2017	$811,703	$251,655	$ 556,648	$ —	$3,400	$313,765

As of September 29, 2017, our estimated amortization of our intangible assets in future fiscal years, subject to the completion of the purchase price allocation for the AppliedMicro, Picometrix, Antario and TPC acquisitions, was as follows (in thousands):

	2018	2019	2020	2021	2022	Thereafter
Amortization expense	$82,798	90,429	88,030	79,161	65,468	211,806

Our trade name is an indefinite-lived intangible asset. During development, in-process research and development (IPR&D) is not subject to amortization and is tested for impairment annually or more frequently if events or changes in circumstances indicate that the asset might be impaired. The impairment test consists of both a qualitative and quantitative assessment using an assumption of 'more likely than not' to determine if there were any impairment indicators. If impairment exists, a loss is recognized in an amount equal to that excess. Once an IPR&D project is complete, it becomes a definite long-lived intangible asset and is evaluated for impairment in accordance with our policy for long-lived assets. During the fourth quarter of fiscal year 2017, we completed the last IPR&D project and placed the acquired technology into service. Prior to placing the technology into service we performed an impairment assessment, at which time we determined that the value of the technology was impaired by $4.4 million, which was expensed in our fiscal fourth quarter of 2017. The remaining $3.6 million was placed in service as acquired technology.

Accumulated amortization for the acquired technology and customer relationships was $106.8 million and $83.9 million, respectively, as of September 29, 2017, and $76.7 million and $48.1 million, respectively, as of September 30, 2016.

During the second quarter of fiscal year 2016, we made a strategic decision to exit the product line and end programs associated with our GaN-on-SiC license and technology transfer to focus on development of our GaN-on-Si efforts. As a result of this strategic decision, we determined that the intangible assets and contractual commitments under the long-term technology licensing and transfer agreement signed in July 2013, as well as certain dedicated fixed assets and inventory, would no longer have any future benefit. The associated charges incurred during the nine months ended July 1, 2016 were $13.8 million, which included a write-off of $10.1 million of intangible assets, $0.6 million of property and equipment, $1.1 million of contractual commitments and $2.0 million of inventory.

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17. INCOME TAXES

Deferred income taxes reflect the net effect of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and amounts used for income tax purposes. The components of our deferred tax assets and liabilities are as follows (in thousands):

	September 29, 2017	September 30, 2016
Deferred tax assets (liabilities):		
Federal and foreign net operating losses and credits	$ 396,871	$ 85,256
Intangible assets	(180,544)	(49,725)
Property and equipment	(1,045)	(2,730)
Other non-current deferred tax assets	20,756	21,855
Discontinued operations	—	9,100
Deferred compensation	9,291	5,545
Deferred gain	14,853	19,011
Valuation allowance	(274,406)	(10,471)
Total deferred tax (liability) asset	$ (14,224)	$ 77,841

Included in the above table are the attributes of our Japan jurisdiction which is in a net liability position of $8.8 million relating primarily to intangible assets.

In fiscal year 2016 we adopted ASU No. 2015-17, Balance Sheet Classification of Deferred Taxes. Upon adoption we included our current deferred income tax assets with our noncurrent deferred income tax assets; no adjustments were made to deferred tax liabilities.

As of September 29, 2017, we had $1,084.8 million of gross federal net operating loss (NOL) carryforwards consisting of $772.7 million relating to the AppliedMicro Acquisition, $158.9 million relating to the Mindspeed Acquisition, $26.2 million relating to the BinOptics Acquisition and $127.0 million relating to losses generated by MACOM. The federal NOL carryforwards will expire at various dates through 2036. The reported net operating loss carryforward includes any limitation under Sections 382 and 383 of the Internal Revenue Code of 1986, as amended, which applies to an ownership change as defined under Section 382.

During the fourth quarter of fiscal year 2016, we identified and corrected a prior period error where we understated our income tax benefit during 2013 through 2015. This was a result of the incorrect recording of intercompany pretax income among a few of our operating entities and due to the fact that these entities had different statutory tax rates. The out-of-period correction resulted in a $3.9 million increase in income tax benefit in the fiscal year ended September 30, 2016 of which $1.7 million, $1.0 million and $1.2 million related to the prior fiscal years 2015, 2014 and 2013, respectively.

The domestic and foreign income (loss) from continuing operations before taxes were as follows (in thousands):

	Fiscal Years		
	2017	2016	2015
United States	$(111,432)	$(46,593)	$(34,251)
Foreign	61,927	25,022	18,851
(Loss) income from operations before income taxes	$(49,505)	$(21,571)	$(15,400)

The components of the provision (benefit) for income taxes are as follows (in thousands):

	Fiscal Years		
	2017	2016	2015
Current:			
Federal	$100	$(5,861)	$(19,015)
State	225	(766)	688

Foreign	7,307	906	1,092
Current provision (benefit)	7,632	(5,721)	(17,235)
Deferred:			
Federal	(42,637)	(8,163)	10,845
State	(4,037)	(502)	(4,131)
Foreign	(466)	(2,603)	(1,302)
Change in valuation allowance	140,419	(994)	1,965
Deferred provision (benefit)	93,279	(12,262)	7,377
Total provision (benefit)	$100,911	$(17,983)	$(9,858)

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We recognize deferred tax assets to the extent that we believe that these assets are more likely than not to be realized. In making this determination, we consider available positive and negative evidence and factors that may impact the valuation of our deferred tax asset including results of recent operations, future reversals of existing taxable temporary differences, projected future taxable income, and tax-planning strategies. A significant piece of objective negative evidence evaluated was the cumulative U.S. loss incurred over the three-year period ended September 29, 2017 which we believe limited our ability to consider other subjective evidence, such as our projections for future growth. Certain transaction and integration related expenses incurred in the U.S., associated primarily with the AppliedMicro Acquisition during the three months ended March 31, 2017, resulted for the first time in significant negative objective evidence in the form of adjusted cumulative losses in the U.S. over the past three-year period. This resulted in our determination that there was not sufficient objectively verifiable positive evidence to offset this negative objective evidence and we concluded that a full valuation allowance totaling $93.5 million was required for our U.S. deferred tax assets as of September 29, 2017. In addition, a full valuation allowance was established against the U.S. deferred tax assets acquired in connection with the AppliedMicro Acquisition.

The $274.4 million of valuation allowance as of September 29, 2017 relates primarily to federal and state NOLs and tax credit carryforwards assumed in the AppliedMicro Acquisition along with an establishment of a full valuation allowance against our U.S. deferred tax assets, and UK tax credit and NOL carryforwards whose recovery is not considered more likely than not. The $10.5 million of valuation allowance as of September 30, 2016 related primarily to state NOL and tax credit carryforwards assumed in the Mindspeed Acquisition and UK tax credit and NOL carryforwards whose recovery is not considered more likely than not. The change during the year ending September 29, 2017 of $263.9 million primarily relates to state NOL and tax credit carryforwards assumed in the AppliedMicro Acquisition along with an establishment of a full valuation allowance against our U.S. deferred tax assets.

Our effective tax rates differ from the federal and statutory rate as follows:

	Fiscal Years		
	2017	2016	2015
Federal statutory rate	35.0%	35.0%	35.0%
Foreign rate differential	31.9	40.1	30.5
State taxes net of federal benefit	0.2	1.0	3.5
Warrant liabilities	(1.8)	(26.7)	(13.7)
Change in valuation allowance	(270.0)	3.0	(6.0)
Research and development credits	12.8	16.9	16.1
Correction of prior period	—	18.3	—
Provision to return adjustments	(4.0)	3.5	9.9
Nondeductible compensation expense	(4.1)	(9.2)	(8.9)
Nondeductible legal fees	(3.9)	(1.8)	(4.1)
Other permanent differences	0.1	3.3	1.6
Effective income tax rate	(203.8)%	83.4%	63.9%

For fiscal years 2017, 2016 and 2015, the effective tax rates to calculate the tax benefit on $49.5 million, $21.6 million and $15.4 million, respectively, of pre-tax loss from continuing operations were (203.8)%, 83.4% and 63.9%, respectively. The effective income tax rate for fiscal years 2017, 2016 and 2015 were primarily impacted by a lower income tax rate in many foreign jurisdictions in which our foreign subsidiaries operate, research and development tax credits, and the fair market value adjustment of warrant liabilities. For fiscal year 2017, the effective tax rate was also impacted by an establishment of a full valuation allowance against our U.S. deferred tax assets. For fiscal years 2015 and 2016, the rate was impacted by a retroactive enactment of the R&D tax credit from fiscal years 2014 and 2015, respectively, and a larger shift of the revenue associated with foreign entities taxed at lower rates as part of our auto divestiture.

All earnings of foreign subsidiaries are considered indefinitely reinvested for the periods presented. Undistributed earnings of all foreign subsidiaries as of September 29, 2017 aggregated $158.6 million, with Ireland and Grand Cayman accounting for $58.3 million and $90.1 million, respectively. It is not practicable to determine the U.S. federal and state deferred tax liabilities associated with such foreign earnings.

Activity related to unrecognized tax benefits is as follows (in thousands):

	Amount
Balance - October 2, 2015	(1,670)
Additions based on tax positions	—
Reductions based on tax positions	—
Balance - September 30, 2016	$(1,670)
Additions based on tax positions	—
Reductions based on tax positions	—
Balance at September 29, 2017	$(1,670)

The balance of the unrecognized tax benefit as of September 29, 2017, is included in other long-term liabilities in the accompanying consolidated balance sheets. Due to the establishment of a full valuation allowance against our U.S. deferred tax assets, only $0.3 million of the entire balance of unrecognized tax benefits, if recognized, will reduce income tax expense. It is our policy to recognize any interest and penalties accrued related to unrecognized tax benefits in income tax expense. During fiscal year 2017, we did not make any payment of interest and penalties. There was nothing accrued in the consolidated balance sheets for the payment of interest and penalties at September 29, 2017, as the remaining unrecognized tax benefits would only serve to reduce our current federal and state NOL carryforwards, if ultimately recognized.

A summary of the fiscal tax years that remain subject to examination, as of September 29, 2017, for the Company's significant tax jurisdictions are:

Jurisdiction	Tax Years Subject to Examination
United States—federal	2013 - forward
United States—various states	2013 - forward
Ireland	2012 - forward

Generally, we are no longer subject to federal income tax examinations for years before 2013, except to the extent of loss and tax credit carryforwards from those years.

18. SHARE-BASED COMPENSATION PLANS

Stock Plans

We have three equity incentive plans: the Amended and Restated 2009 Stock Incentive Plan (2009 Plan), the 2012 Omnibus Incentive Plan, as amended (2012 Plan) and the 2012 Employee Stock Purchase Plan, as amended and restated (ESPP).

Upon the closing of our initial public offering, all shares that were reserved under the 2009 Plan but not awarded were assumed by the 2012 Plan. No additional awards will be made under the 2009 Plan. Under the 2012 Plan, we have the ability to issue incentive stock options (ISOs), nonqualified stock options (NQs), stock appreciation rights, restricted stock (RSAs), restricted stock units (RSUs), performance-based stock units (PRSUs) and other equity-based awards to employees, directors and outside consultants. The ISOs and NQs must be granted at a price per share not less than the fair value of our common stock on the date of grant. Options granted to date primarily vest based on certain market-based and performance-based criteria as described below. Certain of the share-based awards granted and outstanding as of September 29, 2017, are subject to accelerated vesting upon a sale of the Company or similar changes in control. Options granted generally have a term of seven to ten years.

As of September 29, 2017, we had 13.0 million shares available for future issuance under the 2012 Plan. The financial impact of any modifications to share-based awards during the periods presented was not material.

Outside of the three equity plans described above, we also grant incentive stock units (ISUs) liability awards to our international employees which typically vest over 4 years and for which the fair value is determined by our underlying stock price, which are settled in cash. As of September 29, 2017, we had approximately 203,000 ISU awards outstanding with a liability value of $4.4 million recorded as accrued compensation. The related expense for these cash based incentive awards was $3.9 million, $4.0 million and $1.8 million in fiscal years 2017, 2016 and 2015, respectively.

Share-Based Compensation

The following table shows a summary of share-based compensation expense included in the Consolidated Statement of Operations during the periods presented (in thousands):

	Fiscal Years		
	2017	2016	2015
Cost of revenue	$3,189	$2,150	$1,949
Research and development	10,565	6,568	5,447
Selling, general and administrative	22,581	18,236	12,039
Total	$36,335	$26,954	$19,435

Amounts presented above include share-based compensation expense of $0.8 million for fiscal year 2017, which is recorded as discontinued operations related to employees of our Compute business and share-based compensation expense of $0.4 million for fiscal year 2015 related to employees terminated in conjunction with the Automotive divestiture in August 2015.

As of September 29, 2017, the total unrecognized compensation costs, adjusted for estimated forfeitures, related to outstanding stock options, restricted stock awards and units including awards with time-based and performance-based vesting was $62.1 million, which we expect to recognize over a weighted-average period of 2.5 years.

Stock Options

A summary of stock option activity for fiscal year 2017 is as follows (in thousands, except per share amounts):

	Number of Shares	Weighted-Average Exercise Price per Share	Weighted-Average Remaining Contractual Term (in Years)	Aggregate Intrinsic Value
Options outstanding - September 30, 2016	1,048	$ 23.18		
Granted (1)	379	44.74		
Exercised	(234)	13.34		
Forfeited, canceled or expired	(16)	56.80		
Options outstanding - September 29, 2017	1,177	$ 31.61	4.99	16,445
Options vested and expected to vest - September 29, 2017	1,177	$ 31.61	4.99	16,445
Options exercisable - September 29, 2017	397	$ 23.00	4.16	9,701

(1) Includes 59,107 shares that were converted in connection with the AppliedMicro Acquisition.

Aggregate intrinsic value represents the difference between our closing stock price on September 29, 2017, and the exercise price of outstanding, in-the-money options. The total intrinsic value of options exercised was $8.9 million, $3.7 million and $7.1 million for fiscal year 2017, 2016 and 2015, respectively.

Stock Options with Performance-based Vesting Criteria

We granted approximately 230,000 non-qualified stock options in 2016 and 2015 which will vest subject to certain performance metrics such as revenue and gross margin targets being achieved. The aggregate fair value of these stock options was approximately $2.4 million on the date of grant, and the options are subject to vesting based on performance and service conditions being met. We used a Black-Scholes option pricing model for estimating the fair value on the date of grant which ranged from $10.12 to $10.54 per option share. The fair value of stock options is affected by valuation assumptions, including volatility, the Company’s stock price, expected term of the option, risk-free interest rate and expected dividends. These stock options will fully vest and become exercisable if certain performance criteria are met or exceeded in any period of four consecutive fiscal quarters completed during the term of the options based on pre-established revenue and gross margin targets. The stock options have a term of seven years, assuming continued employment with or services to the Company, and have a weighted average exercise price of $34.22 and equal to the closing price of the Company’s common stock on the date of grant. As of September 29, 2017, 50,000 shares of the performance-based stock options granted in fiscal year 2015 had vested as their performance metric had been met and all of the expense associated with these options had been fully recognized.

The weighted average Black-Scholes input assumptions used for calculating the fair value of these performance-based stock options are as follows:

	Fiscal Years	
	2016	2015
Risk-free interest rate	1.15%	1.2 %
Expected term (years)	4	4
Expected volatility	31.8%	36.2%
Expected dividends	— %	— %

Stock Options with Market-based Vesting Criteria

In January 2017, we granted 10,000 non-qualified stock options with a grant date fair value of $0.2 million that are subject to vesting only upon the market price of our underlying public stock closing above a certain price target within seven years of the date of grant. These non-qualified stock options with market related vesting conditions were valued using a Monte Carlo simulation model. Share-based compensation expense is recognized regardless of the number of

awards that are earned based on the market condition and is recognized on a straight-line basis over the estimated service period of approximately three years. In the event that the Company's underlying public stock achieves the target price of $80.70 per share based on a 30 day trailing average prior to the end of the estimated service period, any remaining unamortized compensation cost will be recognized.

In November 2016, we granted 310,000 non-qualified stock options with a grant date fair value of $4.1 million that are subject to vesting only upon the market price of our underlying public stock closing above a certain price target within seven years of the date of grant. These non-qualified stock options with market related vesting conditions were valued using a Monte Carlo simulation model. Share-based compensation expense is recognized regardless of the number of awards that are earned based on the market condition and is recognized on a straight-line basis over the estimated service period of approximately three years. In the event that the Company's

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underlying public stock achieves the target price of $66.96 per share based on a 30 day trailing average prior to the end of the estimated service period, any remaining unamortized compensation cost will be recognized
During fiscal year 2016, we granted 300,000 non-qualified stock options with a grant date fair value of $3.5 million that are subject to vesting only upon the market price of our underlying public stock closing above a certain price target within seven years of the date of grant. These non-qualified stock options with market related vesting conditions were valued using a Monte Carlo simulation model. Share-based compensation expense is recognized regardless of the number of awards that are earned based on the market condition and is recognized on a straight-line basis over the estimated service period of approximately three years. In the event that the Company's underlying public stock achieves the target price of $64.22 per share based on a 30 day trailing average prior to the end of the estimated service period, any remaining unamortized compensation cost will be recognized.
During fiscal year 2015, we granted 30,000 stock options awards, with an exercise price of $29.80, under the 2012 Plan with a grant date fair value of $0.4 million that are subject to vesting only upon the market price of the Company's underlying public stock closing at $63.60 for at least a consecutive three trading day period. These stock options' fair value of $12.38 per option was estimated using a Monte Carlo simulation model based on the market conditions vesting condition. Compensation cost is recognized on a straight-line basis over the estimated service period of approximately three years, expiring in September 2022. On July 26, 2017, our common stock closed above $63.60 per share for a consecutive three trading day period which resulted in the vesting of these market-based stock options and the corresponding expense was accelerated and fully recognized.
The weighted average Monte Carlo input assumptions used for calculating the fair value of these market-based stock options are as follows:

	Fiscal Years		
	2017	2016	2015
Risk-free interest rate	1.9 %	2.1 %	1.9 %
Expected term (years)	7	7	7
Expected volatility	32.3%	36.5%	37.4%

Restricted Stock Awards and Units
A summary of restricted stock awards and units activity for fiscal year 2017 is as follows (in thousands):

	Number of Shares	Weighted-Average Grant Date Fair Value	Aggregate Intrinsic Value
Issued and unvested - September 30, 2016	1,708	$ 32.76	$ 72,165
Granted (1)	1,276	37.92	
Vested	(984)	26.63	
Forfeited, canceled or expired	(93)	36.30	
Issued and unvested shares - September 29, 2017	1,907	39.20	$ 85,093

(1) Includes 306,089 shares that were converted in connection with the AppliedMicro Acquisition.
As of September 29, 2017, the aggregate intrinsic value of vesting restricted stock units including time-based and performance-based units was $79.3 million for fiscal year 2017. The total fair value of restricted stock awards and units vested was $51.2 million, $26.5 million and $23.3 million for the fiscal years 2017, 2016 and 2015, respectively.
In addition to RSUs, we also issue PRSUs with specific performance vesting criteria. These PRSUs have both a service and performance-based vesting condition and awards are divided into three equal tranches and vest based on achieving certain adjusted earnings per share (EPS) growth metrics. The service condition requires participants to be employed on May 15th of the following year once the performance condition has been met. Depending on the actual performance achieved, a participant may earn between 0% to 300% of the targeted shares for each tranche, which is determined based on a straight-line interpolation applied for the achievement between the specified performance ranges. As of September 29, 2017, the performance condition for 75,349 target shares had been met, and 203,011 shares with a total grant date fair value of $7.1 million are expected to vest in May 2018 when the service condition is

achieved. We granted 69,109 PRSUs shares during fiscal year 2017. The amount of incremental PRSU awards that could ultimately vest if all performance criteria are achieved would be 442,605 shares assuming a maximum of 300% of the targeted shares.

Employee Stock Purchase Plan (ESPP)

The ESPP allows eligible employees to purchase shares of our common stock at a discount through payroll deductions of up to 15% of their eligible compensation, subject to any plan limitations. In administering the ESPP, the board of directors has limited discretion to set the length of the offering periods thereunder. As of September 29, 2017, total unrecognized compensation cost related to the ESPP

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was not material. In fiscal years 2017, 2016 and 2015, approximately 146,149, 154,187 and 175,900, respectively, of shares of common stock were issued under the ESPP.

The 2012 Plan contains an "evergreen" provision, pursuant to which the number of shares of common stock available for issuance under the 2012 Plan can be increased on the first day of each fiscal year by the lesser of (a) 4.0% of outstanding common stock on a fully diluted basis as of the end of the immediately preceding fiscal year, (b) 1.9 million shares of common stock and (c) a lesser amount determined by the board of directors; provided, however, that any shares from any increases in previous years that are not actually issued will continue to be available for issuance under the 2012 Plan. The ESPP also contains an "evergreen" provision, pursuant to which the number of shares of common stock available for issuance under the ESPP can be increased on the first day of each fiscal year by the lesser of (a) 1.25% of outstanding common stock on a fully diluted basis as of the end of the immediately preceding fiscal year, (b) 550,000 shares of common stock and (c) a lesser amount determined by the board of directors; provided, however, that any shares from any increases in previous years that are not actually issued will continue to be available for issuance under the ESPP. In fiscal year 2017, pursuant to the evergreen provisions, the number of shares of common stock available for issuance under the 2012 Plan and the ESPP were increased by 1.9 million shares and 550,000 shares, respectively.

19. STOCKHOLDERS' EQUITY

We have authorized 10 million shares of $0.001 par value preferred stock and 300 million shares of $0.001 par value common stock as of September 29, 2017 and September 30, 2016. The outstanding shares of common stock as of September 29, 2017 and September 30, 2016, presented in the accompanying consolidated statements of stockholders' equity, exclude 200 and 3,300 unvested shares of restricted stock awards, respectively, issued as compensation to employees that were subject to forfeiture.

Common Stock Warrants—In March 2012, we issued warrants to purchase 1,281,358 shares of common stock for $14.05 per share. The warrants expire December 21, 2020, or earlier as per the terms of the agreement, including immediately following consummation of a sale of all or substantially all assets or capital stock or other equity securities, including by merger, consolidation, recapitalization or similar transactions. We do not currently have sufficient registered and available shares to immediately satisfy a request for registration, if such a request were made. As of September 29, 2017, no exercise of the warrants had occurred and no request had been made to register the warrants or any underlying securities for resale by the holders.

We are recording the estimated fair values of the warrants as a long-term liability in the accompanying consolidated financial statements with changes in the estimated fair value being recorded in the accompanying statements of operations.

20. RELATED-PARTY TRANSACTIONS

GaAs Labs, LLC (GaAs Labs), a former stockholder and an affiliate of directors John and Susan Ocampo, continues to engage us to provide administrative and business development services to GaAs Labs on a time and materials basis. There are no minimum service requirements or payment obligations and the agreement may be terminated by either party with 30 days notice. In the fiscal years 2017, 2016 and 2015 we recorded no material billings to GaAs Labs.

Cadence Design Systems, Inc. (Cadence) provides us with certain engineering licenses on an ongoing basis. Geoffrey Ribar, who joined our board of directors on March 22, 2017, served as an officer of Cadence through September 30, 2017. During fiscal year 2017, we made payments of $6.3 million to Cadence subsequent to Mr. Ribar joining the board of directors.

In fiscal years 2017 and 2016 we recorded no material revenue associated with product sales to a public company with a common director. In fiscal year 2015, we recorded revenue of $1.1 million associated with product sales to a public company with a common director.

21. DISCONTINUED OPERATIONS

In connection with the acquisition of AppliedMicro, we announced a plan to divest its Compute business. As of September 29, 2017, the Compute business was being actively marketed, and we expected to complete any such divestment within twelve months from the date of acquisition. We are accounting for the business as a discontinued operation. For additional information related to the divestiture of the Compute business refer to Note 27 - Subsequent

Events.

In August of fiscal year 2015, we sold our Automotive business to Autoliv ASP Inc. (Autoliv) as the Automotive business was not consistent with our long-term strategic vision from both a growth and profitability perspective. The agreed consideration included $82.1 million in cash paid at closing and $18.0 million payable in eighteen months pending resolution of any contingencies as part of an indemnification agreement, plus the opportunity to receive up to an additional $30.0 million in cash based on achievement of revenue-based earnout targets through 2019. Additionally, we entered into a Consulting Agreement pursuant to which we may provide Autoliv with certain non-design advisory services for a period of two years following the closing of the transaction for up to $15.0 million in cash (the Consulting Agreement), from which we have recorded $7.5 million as other income during both fiscal years 2017 and 2016.

During fiscal year 2015, we recorded a pre-tax gain on the sale of the Automotive business of $61.8 million based on the $82.1 million received at closing on August 17, 2015, as described above. During fiscal year 2017, we received $18.0 million, the full amount of the indemnification escrow. The remainder of the consideration to be received from Autoliv, if any, including any additional amounts

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related to the Consulting Agreement, will be accounted for in discontinued operations when the contingencies are finalized and the proceeds, if any, become realizable.
In fiscal year 2014, subsequent to closing the Mindspeed Acquisition, we divested the wireless business of Mindspeed. The operations of the wireless business are included in discontinued operations through the date of sale. There was no initial gain or loss on the sale, which closed in February 2014. The selling price of the wireless business was $12.3 million and was received upon settlement of all indemnification holdbacks during fiscal year 2014. The final settlement of $1.6 million was received in September 2015, and recorded as a pre-tax gain within discontinued operations.
The accompanying consolidated statement of operations includes the following operating results related to these divested businesses (in thousands):

	Fiscal Years		
	2017	2016	2015
Revenue (1)	$660	$ —	$71,712
Cost of revenue (1)	2,252	—	46,931
Gross (loss) profit	(1,592)	—	24,781
Operating expenses:			
Research and development (1)	29,167	—	2,319
Selling, general and administrative (1)	13,840	—	2,441
Total operating expenses	43,007	—	4,760
(Loss) income from discontinued operations (1)	(44,599)	—	20,021
Other income (2)	7,500	7,500	4,000
Gain on sale (3)	18,022	308	63,321
(Loss) income before income taxes	(19,077)	7,808	87,342
Income tax provision (benefit)	—	2,786	33,211
(Loss) income from discontinued operations	(19,077)	5,022	54,131
Above includes depreciation & amortization of (2)	—	—	189
Cash flow from Operating Activities (4)	(42,776)	—	(8,522)
Cash flow from Investing Activities (2)	25,522	7,500	(505)

(1) Amounts for fiscal year 2015 are associated with the Automotive business, and amounts for fiscal year 2017 are associated with the Compute business.
(2) Amounts are associated with the Automotive business.
(3) Fiscal year 2015 amounts include $1.6 million associated with the Mindspeed wireless business, and the remaining amounts are associated with the Automotive business.
(4) Amounts for fiscal year 2015 are associated with the Automotive business and Mindspeed wireless business, and amounts for fiscal year 2017 are associated with the Compute business.

For the fiscal year ended September 29, 2017, we recorded assets held for sale of $35.6 million, which included inventory and other assets of $1.3 million, property and equipment of $7.8 million, goodwill and intangibles of $28.4 million, as well as a $2.0 million provision for disposition costs. During the same period, liabilities held for sale amounted to $2.1 million.

22. EARNINGS PER SHARE

The following table set forth the computation for basic and diluted net income (loss) per share of common stock (in thousands, except per share data):

	Fiscal Years		
	2017	2016	2015
Numerator:			
Loss from continuing operations	$(150,416)	$(3,588)	$(5,542)
(Loss) income from discontinued operations	(19,077)	5,022	54,131
Net (loss) income	(169,493)	1,434	48,589
Net (loss) income attributable to common stockholders	$(169,493)	$1,434	$48,589
Denominator:			
Weighted average common shares outstanding-basic	60,704	53,364	51,146
Weighted average common shares outstanding-diluted	60,704	53,364	51,146
Common stock earnings per share-basic:			
Continuing operations	$(2.48)	$(0.07)	$(0.11)
Discontinued operations	(0.31)	0.09	1.06
Net common stock earnings per share-basic	$(2.79)	$0.03	$0.95
Common stock earnings per share-diluted:			
Continuing operations	$(2.48)	$(0.07)	$(0.11)
Discontinued operations	(0.31)	0.09	1.06
Net common stock earnings per share-diluted	$(2.79)	$0.03	$0.95

The table above excludes the effects of 1,877,401, 1,855,049 and 2,055,779 shares for fiscal years 2017, 2016 and 2015, respectively, of potential shares of common stock issuable upon exercise of stock options, restricted stock and restricted stock units and warrants as the inclusion would be antidilutive.

23. SUPPLEMENTAL CASH FLOW INFORMATION

As of September 29, 2017 and September 30, 2016, we had $7.6 million and $0.8 million, respectively, in unpaid amounts related to purchases of property and equipment and intangibles included in accounts payable and accrued liabilities during each period. These amounts have been excluded from the payments for purchases of property and equipment in the accompanying consolidated statements of cash flows until paid.

In January 2017, we issued common stock with a fair value of $465.1 million in connection with the AppliedMicro Acquisition. This was accounted for as a non-cash transaction as no shares were purchased or sold as part of the transaction.

As of September 29, 2017, we capitalized $3.6 million relating to the construction of the 144 Chelmsford Street facility. This was accounted for as a non-cash transaction as the costs were paid by Calare Properties, Inc.

The following is supplemental cash flow information regarding noncash investing and financing activities (in thousands):

	Fiscal Years		
	2017	2016	2015
Cash paid for interest	$30,529	$16,335	$15,607
Cash paid (refunded) for income taxes	$(3,161)	$(373)	$22,676

24. ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)

The components of accumulated other comprehensive income (loss), net of income taxes, are as follows:

	Foreign Currency Items	Other Items	Total
Balance - October 2, 2015	$(2,182)	$(97)	$(2,279)
Foreign currency translation, net of tax	11,320	—	11,320
Unrealized gain/loss on short term investments	—	(2)	(2)
Balance - September 30, 2016	9,138	(99)	9,039
Foreign currency translation, net of tax	(5,999)	—	(5,999)
Unrealized gain/loss on short term investments	—	(63)	(63)
Balance at September 29, 2017	$3,139	$(162)	$2,977

25. GEOGRAPHIC AND SIGNIFICANT CUSTOMER INFORMATION

We have one reportable operating segment that designs, develops, manufactures and markets semiconductors and modules. The determination of the number of reportable operating segments is based on the chief operating decision maker's use of financial information for the purposes of assessing performance and making operating decisions. In evaluating financial performance and making operating decisions, the chief operating decision maker primarily uses consolidated revenue, gross profit and operating income (loss).

Information about our operations in different geographic regions, based upon customer locations, is presented below (in thousands):

	Fiscal Years		
Revenue by Geographic Region	2017	2016	2015
United States	$265,038	$155,998	$152,974
China	206,136	201,911	127,428
Asia Pacific, excluding China (1)	170,826	144,872	103,941
Other Countries (2)	56,772	41,557	36,266
Total	$698,772	$544,338	$420,609

(1) Asia Pacific represents Taiwan, Japan, Singapore, India, Thailand, South Korea, Australia, Malaysia, New Zealand, the Philippines and Vietnam.

(2) No international country or region represented greater than 10% of the total revenue as of the dates presented, other than China and the Asia-Pacific region as presented above.

	As of	
	September 29,	September 30,
Long-Lived Assets by Geographic Region	2017	2016
United States	$101,044	$ 79,832
Asia Pacific (1)	24,945	16,614
Other Countries (2)	5,030	2,721
Total	$131,019	$ 99,167

(1) Asia Pacific represents Taiwan, Japan, Singapore, India, Thailand, South Korea, Australia, Malaysia, New Zealand, the Philippines, Vietnam and China.

(2) No international country or region represented greater than 10% of the total net long-lived assets as of the dates presented, other than the Asia-Pacific region as presented above.

The following is a summary of customer concentrations as a percentage of total sales and accounts receivable as of and for the periods presented:

Fiscal Years

Revenue	2017	2016	2015
Customer A	11 %	11 %	18 %
Customer B	10 %	15 %	8 %
Customer C	6 %	12 %	12 %

Accounts Receivable	September 29, 2017	September 30, 2016
Customer A	13 %	11 %
Customer B	5 %	11 %
Customer C	6 %	16 %
Customer D	14 %	2 %

No other customer represented more than 10% of revenue or accounts receivable in the periods presented in the accompanying consolidated financial statements. In fiscal years 2017, 2016 and 2015, our top ten customers represented an aggregate of 52%, 62% and 57% of total revenue, respectively.

26. QUARTERLY FINANCIAL DATA (UNAUDITED)

(In thousands, except per share data)

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Fiscal Year
Fiscal Year 2017					
Revenue	$151,752	$186,084	$194,555	$166,381	$698,772
Gross profit	78,495	68,864	92,629	86,896	326,884
(Loss) income from continuing operations	(2,171)	(134,267)	(13,977)	(1)	(150,416)
Income (loss) from discontinued operations (1)	1,206	4,136	(13,700)	(10,719)	(19,077)
Per share data (2)					
Loss from continuing operations, basic	$(0.04)	$(2.21)	$(0.22)	$(0.00)	$(2.48)
Income (loss) from discontinued operations, basic	$0.02	$0.07	$(0.21)	$(0.17)	$(0.31)
Per share data (2) (3)					
Loss from continuing operations, diluted	$(0.04)	$(2.21)	$(0.22)	$(0.21)	$(2.48)
Income (loss) from discontinued operations, diluted	$0.02	$0.07	$(0.21)	$(0.16)	$(0.31)
Fiscal Year 2016					
Revenue	$115,774	$133,579	$142,288	$152,697	$544,338
Gross profit	60,318	65,525	73,962	81,804	281,609
(Loss) income from continuing operations	(16,770)	(12,045)	21,353	3,874	(3,588)
Income from discontinued operations	1,199	1,396	1,199	1,228	5,022
Per share data (2)					
(Loss) income from continuing operations, basic	$(0.32)	$(0.23)	$0.40	$0.07	$(0.07)
Income from discontinued operations, basic	$0.02	$0.03	$0.02	$0.02	$0.09
Per share data (2) (3)					
(Loss) income from continuing operations, diluted	$(0.32)	$(0.23)	$0.11	$0.07	$(0.07)
Income from discontinued operations, diluted	$0.02	$0.03	$0.02	$0.02	$0.09

(1) During the second quarter of fiscal year 2017, we announced a plan to divest the Compute business of AppliedMicro, and have included the results of the Compute business as discontinued operations in each subsequent quarter.

(2) Earnings per share calculations for each of the quarters are based on the weighted average number of shares outstanding and included common stock equivalents in each period. Therefore, the sums of the quarters do not necessarily equal the full year earnings per share.

(3) Diluted income (loss) per share for the fiscal fourth quarter 2017 and fiscal third quarter 2016 excludes $14.0 million and $15.3 million, respectively, related to warrant liability gain.

27. SUBSEQUENT EVENTS

On October 27, 2017, we and MACOM Connectivity Solutions, LLC (MACOM Connectivity), formerly known as AppliedMicro, our wholly-owned, indirect subsidiary, entered into a Purchase Agreement (the Purchase Agreement) with Project Denver Holdings LLC (Buyer), to sell the Compute business. In consideration for the transfer and sale of the Compute business, MACOM Connectivity received an equity interest in the Buyer valued at approximately $36.5 million and representing less than 20% of the Buyer's total outstanding equity. Under the Purchase Agreement, we agreed to guarantee the financial obligations of MACOM Connectivity, thereunder and to cause the delivery of the Compute business assets transferable to Buyer according to its terms.

The transactions contemplated by the Purchase Agreement closed contemporaneously with its signing, with the exception of the transfer of certain assets and entities related to the Compute business that are held outside of the United States, which will be transferred upon receipt of applicable foreign approvals.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE.

None.

ITEM 9A. CONTROLS AND PROCEDURES.

Evaluation of Disclosure Controls and Procedures

We maintain disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act), that are intended to ensure that information that would be required to be disclosed in Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our management, including the Principal Executive Officer and the Principal Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

An evaluation was performed, under the supervision, and with the participation of our management, including our Principal Executive Officer and Principal Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures as of September 29, 2017. We acquired AppliedMicro on January 26, 2017 and subsequently integrated their existing financial reporting processes and procedures into our financial reporting internal control structure. Accordingly, the scope of our evaluation including the effectiveness of our disclosure controls for fiscal year 2017 excluded internal controls related to financial reporting for periods prior to AppliedMicro integration. AppliedMicro's pre-integration revenue constituted approximately 11% of our consolidated revenue for the fiscal year ended September 29, 2017. Based on this evaluation, our Principal Executive Officer and Principal Financial Officer concluded that our disclosure controls and procedures were effective as of September 29, 2017 at the reasonable assurance level.

Management's Annual Report on Internal Control over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting. Internal control over financial reporting is defined in Rule 13a-15(f) or 15d-15(f) promulgated under the Securities Exchange Act of 1934 as a process designed by, or under the supervision of, the company's principal executive and principal financial officers and effected by the company's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:

- Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the company;
- Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and,
- Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Our management assessed the effectiveness of our internal control over financial reporting as of September 29, 2017. In making this assessment, the company's management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control-Integrated 2013 Framework.

Based on this assessment, our management concluded that, as of September 29, 2017, our internal control over financial reporting is effective based on those criteria.

The effectiveness of our internal control over financial reporting as of September 29, 2017 has been audited by Deloitte & Touche LLP, an independent registered public accounting firm, as stated in their report which is included herein.

Changes in Internal Control over Financial Reporting

There have been no changes in the Company’s internal control over financial reporting that occurred during the year ended September 29, 2017 that have materially affected, or are reasonably likely to materially affect, the Company’s internal control over financial reporting.

Report of Independent Registered Public Accounting Firm
To the Board of Directors and Stockholders of
MACOM Technology Solutions Holdings, Inc.
Lowell, Massachusetts

We have audited the internal control over financial reporting of MACOM Technology Solutions Holdings, Inc. and subsidiaries (the "Company") as of September 29, 2017, based on criteria established in Internal Control - Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission. As described in "Management's Annual Report on Internal Control Over Financial Reporting" appearing at Item 9A, management excluded from its assessment the internal control over financial reporting at Applied Micro Circuits Corporation, which was acquired on January 26, 2017, and whose financial statements constitute 11 percent of total revenues of the consolidated financial statement amounts as of and for the year ended September 29, 2017. Accordingly, our audit did not include the internal control over financial reporting at Applied Micro Circuits Corporation. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying "Management's Annual Report on Internal Control Over Financial Reporting" appearing at Item 9A. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of September 29, 2017, based on the criteria established in Internal Control - Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of MACOM Technology Solutions Holdings, Inc. and subsidiaries as of September 29, 2017 and September 30, 2016, and the related consolidated statements of operations, comprehensive (loss) income, stockholders' equity, and cash flows for each of the three fiscal years in the period ended September 29,

2017 of the Company and our report dated November 15, 2017 expressed an unqualified opinion on those financial statements.

/s/ Deloitte & Touche LLP
Boston, Massachusetts
November 15, 2017

ITEM 9B. OTHER INFORMATION.

None.

PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE.

The information required by this item is incorporated herein by reference to our definitive proxy statement for the 2018 Annual Meeting of Stockholders to be filed with the SEC within 120 days after September 29, 2017.

We have adopted a written code of business conduct and ethics that applies to our directors, officers and employees, including our principal executive officer, principal financial officer, principal accounting officer or controller, and persons performing similar functions. We make available our code of business conduct and ethics free of charge through our website, which is located at www.macom.com. We intend to disclose any amendments to, or waivers from, our code of business conduct and ethics that are required to be publicly disclosed pursuant to rules of the SEC and the NASDAQ Global Select Market by posting any such amendment or waivers on our website and disclosing any such waivers in a Form 8-K filed with the SEC.

ITEM 11. EXECUTIVE COMPENSATION.

The information required by this item is incorporated herein by reference to our definitive proxy statement for the 2018 Annual Meeting of Stockholders to be filed with the SEC within 120 days after September 29, 2017.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS.

The information required by this item is incorporated herein by reference to our definitive proxy statement for the 2018 Annual Meeting of Stockholders to be filed with the SEC within 120 days after September 29, 2017.

Equity Compensation Plan Information

We have two equity compensation plans under which shares are currently authorized for issuance, our 2012 Omnibus Incentive Plan (2012 Plan) and our 2012 Employee Stock Purchase Plan (2012 ESPP). We also maintain our Amended and Restated 2009 Omnibus Incentive Plan (2009 Plan), however, no additional awards may be issued under the 2009 Plan. Each of our aforementioned plans were approved by our stockholders prior to our initial public offering in March 2012. The following table provides information regarding securities authorized for issuance as of September 29, 2017 under our equity compensation plans.

Plan Category	(a) Number of securities to be issued upon exercise of outstanding options, warrants and rights(1)	(b) Weighted-average exercise price of outstanding options, warrants and rights(1)	(c) Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))(2)(3)
Equity Compensation Plans Approved by Security Holders	2,940,018	$ 12.26	16,033,569
Equity Compensation Plans Not Approved by Security Holders	—	—	—
Total	2,940,018	$ 12.26	16,033,569

(1) Does not include 1,907,331 unvested shares outstanding as of September 29, 2017 in the form of restricted stock awards or restricted stock units under our 2012 Plan, which do not require the payment of any consideration by the recipients.

(2) The 2012 Plan contains an “evergreen” provision, pursuant to which the number of shares of our common stock available for issuance under the 2012 Plan can be increased on the first day of each fiscal year by the lesser of (a) 4.0% of our outstanding common stock on a fully diluted basis as of the end of our immediately preceding fiscal year, (b) 1.9 million shares of our common stock and (c) a lesser amount determined by our board of directors; provided, however, that any shares from any increases in previous years that are not actually issued will continue to be available for issuance under the 2012 Plan.

(3) The 2012 ESPP contains an “evergreen” provision, pursuant to which the number of shares of our common stock available for issuance under the 2012 ESPP can be increased on the first day of each fiscal year by the lesser of (a) 1.25% of our outstanding common stock on a fully diluted basis as of the end of our immediately preceding fiscal year, (b) 550,000 shares of our common stock and (c) a lesser amount determined by our board of directors; provided, however, that any shares from any increases in previous years that are not actually issued will continue to be available for issuance under the 2012 ESPP.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE.

The information required by this item is incorporated herein by reference to our definitive proxy statement for the 2018 Annual Meeting of Stockholders to be filed with the SEC within 120 days after September 29, 2017.

ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES.

The information required by this item is incorporated herein by reference to our definitive proxy statement for the 2018 Annual Meeting of Stockholders to be filed with the SEC within 120 days after September 29, 2017.

PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES.

(a) Financial Statements (included in" Item 8. - Financial Statements and Supplementary Data" of this Annual Report):
Report of Independent Registered Public Accounting Firm
Consolidated Balance Sheets as of September 29, 2017 and September 30, 2016
Consolidated Statements of Operations for the Fiscal Years Ended September 29, 2017, September 30, 2016 and October 2, 2015
Consolidated Statements of Stockholders' Equity and Comprehensive (Loss) Income for the Fiscal Years Ended September 29, 2017, September 30, 2016 and October 2, 2015
Consolidated Statements of Cash Flows for the Fiscal Years September 29, 2017, September 30, 2016 and October 2, 2015
Notes to Consolidated Financial Statements

(b) Exhibits
The exhibits required by Item 601 of Regulation S-K are filed herewith and incorporated by reference herein.

Exhibit Number	Description
2.1	Purchase Agreement by and among MACOM Connectivity Solutions, LLC, Project Denver Holdings LLC, and MACOM Technology Solutions Holdings, Inc., dated October 27, 2017 (incorporated by reference to Exhibit 2.1 to our Current Report on Form 8-K filed on October 27, 2017).
3.1	Fifth Amended and Restated Certificate of Incorporation (incorporated by reference to Exhibit 3.1 to our Current Report on Form 8-K filed on June 2, 2016).
3.2	Third Amended and Restated Bylaws (incorporated by reference to Exhibit 3.2 to our Current Report on Form 8-K filed on June 2, 2016).
4.1	Specimen of Common Stock Certificate (incorporated by reference to Exhibit 4.1 to Amendment No. 4 to our Registration Statement on Form S-1 (File No. 333-175934) filed on November 23, 2011).
4.2	Form of Common Stock Purchase Warrant issued on December 21, 2010 (incorporated by reference to Exhibit 4.3 our Registration Statement on Form S-1 (File No. 333-175934) filed on August 1, 2011).
4.3	Second Amended and Restated Investor Rights Agreement, dated February 28, 2012 (incorporated by reference to Exhibit 4.2 to Amendment No. 6 to our Registration Statement on Form S-1 (File No. 333-175934) filed on February 28, 2012).
4.4	First Amendment to the Second Amended and Restated Investor Rights Agreement, dated May 20, 2013 (incorporated by reference to Exhibit 4.5 to our Registration Statement on Form S-3 (File No. 333-188728) filed on May 21, 2013).
4.5	Second Amendment to the Second Amended and Restated Investor Rights Agreement, dated February 2, 2015 (incorporated by reference to Exhibit 4.5 to our Registration Statement on Form S-3 ASR (File No. 333-201827) filed on February 2, 2015).
10.1*	Form of Indemnification Agreement between MACOM Technology Solutions Holdings, Inc. and each of its directors and executive officers (incorporated by reference to Exhibit 10.1 to Amendment No. 3 to our Registration Statement on Form S-1 (File No. 333-175934) filed on October 21, 2011).
10.2	MACOM Technology Solutions Holdings, Inc. Amended and Restated 2009 Omnibus Stock Plan, as amended (incorporated by reference to Exhibit 10.2 to our Annual Report on Form 10-K filed on November 28, 2012).
10.3	Form of Incentive Stock Option Agreement under the MACOM Technology Solutions Holdings, Inc. 2009 Omnibus Stock Plan (incorporated by reference to Exhibit 10.3 to our Registration Statement on Form S-1

	(File No. 333-175934) filed on August 1, 2011).
10.4*	Form of Restricted Stock Agreement under the MACOM Technology Solutions Holdings, Inc. 2009 Omnibus Stock Plan (incorporated by reference to Exhibit 10.4 to our Registration Statement on Form S-1 (File No. 333-175934) filed on August 1, 2011).
10.5*	MACOM Technology Solutions Holdings, Inc. 2012 Omnibus Incentive Plan, as amended (incorporated by reference to Exhibit 10.5 to our Annual Report on Form 10-K filed on November 28, 2012).
10.6*	Form of Restricted Stock Unit Award Agreement under 2012 Omnibus Incentive Plan (Time-Based and Performance-Based) (incorporated by reference to Exhibit 10.1 to our Current Report on Form 8-K filed on April 27, 2015).

10.7*	Form of Nonqualified Stock Option Agreement under 2012 Omnibus Incentive Plan (Performance-Based) (incorporated by reference to Exhibit 10.2 to our Current Report on Form 8-K filed on April 27, 2015).
10.8*	MA-COM Technology Solutions Holdings, Inc. 2012 Employee Stock Purchase Plan, as amended. (incorporated by reference to Exhibit 10.4 to our Quarterly Report on Form 10-Q filed on February 2, 2015).
10.9*	Offer of Employment Letter to Michael Murphy, dated September 28, 2009, as amended (incorporated by reference to Exhibit 10.13 to our Registration Statement on Form S-1 (File No. 333-175934) filed on August 1, 2011).
10.10*	Offer of Employment to John Croteau, dated September 6, 2012 (incorporated by reference to Exhibit 10.1 to our Current Report on Form 8-K filed on September 7, 2012).
10.11*	Offer of Employment to Robert McMullan, dated December 11, 2013 (incorporated by reference to Exhibit 10.2 to our Current Report on Form 8-K filed on December 16, 2013).
10.12*	Offer of Promotion and Revised Terms of Employment Letter, dated September 24, 2013, between MACOM Technology Solutions Inc. and Robert Dennehy (incorporated by reference to Exhibit 10.1 to our Quarterly Report on Form 10-Q filed on February 2, 2015).
10.13*	Offer of Employment Letter, dated as of December 11, 2013, between MACOM Technology Solutions Inc. and Preetinder Virk (incorporated by reference to Exhibit (d)(8) to Amendment No. 4 to our Tender Offer Statement on Schedule TO filed with the SEC on December 11, 2013).
10.14*	Credit Agreement by and among MACOM Technology Solutions Holdings, Inc., Goldman Sachs Bank USA, as Administrative Agent, Collateral Agent, Swing Line Lender and an L/C Issuer, and the other agents and lenders party thereto, dated May 8, 2014 (incorporated by reference to Exhibit 10.1 to our Current Report on Form 8-K filed on May 12, 2014).
10.15	Incremental Amendment, dated February 13, 2015, among Morgan Stanley Senior Funding, Inc., MACOM Technology Solutions Holdings, Inc., and Goldman Sachs Bank USA (incorporated by reference to Exhibit 10.1 to our Quarterly Report on Form 10-Q filed on May 13, 2015).
10.16	Form of Restricted Stock Award Agreement under 2012 Omnibus Incentive Plan (incorporated by reference to Exhibit 10.1 to our Quarterly Report on Form 10-Q filed on August 12, 2015).
10.17*	Consulting Agreement, dated July 16, 2015, among MACOM Technology Solutions Inc., MACOM Auto Solutions Inc. and Autoliv ASP Inc. (incorporated by reference to Exhibit 10.1 to our Current Report on Form 8-K filed on July 17, 2015).
10.18	Purchase and Sale Agreement and Escrow Instructions by and between MACOM Technology Solutions Inc., and Calare Properties, Inc., dated May 23, 2016 (incorporated by reference to Exhibit 10.1 to our Current Report on Form 8-K filed on June 2, 2016).
10.19	Incremental Term Loan Amendment, dated August 31, 2016, by and among MACOM Technology Solutions Holdings, Inc., Goldman Sachs Bank USA, as the administrative agent, and the lender party thereto (incorporated by reference to our Current Report on Form 8-K filed August 31, 2016).
10.2	First, Second and Third Amendments to Purchase And Sale Agreement and Escrow Instructions by and between MACOM Technology Solutions Inc. and Calare Properties, Inc. dated July 22, 2016, September 20, 2016 and September 22, 2016, respectively (incorporated by reference to Exhibit 10.23 to our Annual Report on Form 10-K filed on November 17, 2016.
10.21	Lease Agreement for 100 Chelmsford Street by and between MACOM Technology Solutions Holdings, Inc., CPI 100 Chelmsford, LLC and CPI 144 Chelmsford, LLC, dated December 28, 2016 (incorporated by reference to Exhibit 10.1 to our Current Report on Form 8-K filed on January 5, 2017).
10.22	Lease Agreement for 144 Chelmsford Street by and between MACOM Technology Solutions Holdings, Inc., CPI 100 Chelmsford, LLC and CPI 144 Chelmsford, LLC, dated December 28, 2016 (incorporated by reference to Exhibit 10.2 to our Current Report on Form 8-K filed on January 5, 2017).
10.23	MACOM Technology Solutions Holdings, Inc. Amended and Restated Change in Control Plan and Form of Participation Notice, amended and restated on February 11, 2017 (incorporated by reference to Exhibit 10.1 to our Current Report on Form 8-K filed on February 16, 2017).

10.25	Second Incremental Amendment, dated as of March 10, 2017, by and among MACOM Technology Solutions Holdings, Inc., Barclays Bank PLC and Goldman Sachs Bank USA, as Administrative Agent (incorporated by reference to Exhibit 10.1 to our Current Report on Form 8-K filed on March 13, 2017).
10.25	Amendment No. 4 to Credit Agreement, dated as of March 10, 2017, by and among MACOM Technology Solutions Holdings, Inc., the revolving credit lenders and Goldman Sachs Bank USA, as Administrative Agent (incorporated by reference to Exhibit 10.2 to our Current Report on Form 8-K filed on March 13, 2017).
10.26	Refinancing Amendment, dated as of March 10, 2017, by and among MACOM Technology Solutions Holdings, Inc., the lenders party thereto and Goldman Sachs Bank USA, as Administrative Agent (incorporated by reference to Exhibit 10.3 to our Current Report on Form 8-K filed on March 13, 2017).

10.27	Second Refinancing Amendment, dated as of May 19, 2017, by and among MACOM Technology Solutions Holdings, Inc., Morgan Stanley Senior Funding, Inc. and the other term lenders party thereto and Goldman Sachs Bank USA, as Administrative Agent (incorporated by reference to Exhibit 10.1 to our Current Report on Form 8-K filed on May 19, 2017).
10.28	Second Incremental Term Loan Amendment, dated as of May 19, 2017, by and among MACOM Technology Solutions Holdings, Inc., Morgan Stanley Senior Funding, Inc., as the initial lender, and Goldman Sachs Bank USA, as Administrative Agent (incorporated by reference to Exhibit 10.2 to our Current Report on Form 8-K filed on May 19, 2017).
21.1	Subsidiaries of Registrant.
23.1	Consent of Deloitte & Touche LLP.
31.1	Certification of Principal Executive Officer Required Under Rule 13a-14(a) and 15d-14(a) of the Securities Exchange Act of 1934, as amended.
31.2	Certification of Principal Financial Officer Required Under Rule 13a-14(a) and 15d-14(a) of the Securities Exchange Act of 1934, as amended.
32.1	Certification of Principal Executive Officer and Principal Financial Officer Required Under Rule 13a-14(b) of the Securities Exchange Act of 1934, as amended, and 18 U.S.C. §1350.
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Calculation Linkbase Document
101.DEF	XBRL Taxonomy Definition Linkbase Document
101.LAB	XBRL Taxonomy Label Linkbase Document
101.PRE	XBRL Taxonomy Presentation Linkbase Document

* Management contract or compensatory plan.

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ITEM 16. FORM 10-K SUMMARY.

None.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this Annual Report to be signed on its behalf by the undersigned, thereunto duly authorized.

Date: November 15, 2017

MACOM TECHNOLOGY SOLUTIONS HOLDINGS, INC.
Registrant

By: /s/ John Croteau
John Croteau
President and Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities indicated on November 15, 2017.

Signature and Title	Signature and Title
/s/ John Croteau John Croteau President and Chief Executive Officer Director (Principal Executive Officer)	/s/ John Ocampo John Ocampo Chairman of the Board
	/s/ Susan Ocampo Susan Ocampo Director
/s/ Robert J. McMullan Robert J. McMullan Senior Vice President and Chief Financial Officer (Principal Accounting and Financial Officer)	/s/ Peter Chung Peter Chung Director
	/s/Gil Van Lunsen Gil Van Lunsen Director
	/s/ Charles Bland Charles Bland Director
	/s/ Stephen Daly Stephen Daly Director
	/s/ Geoffrey Ribar Geoffrey Ribar

Director

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