APPLE COMPUTER INC
Form 10-Q
February 03, 2006

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(Mark One)

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

For the quarterly period ended December 31, 2005

or

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

For the transition period from to .

Commission file number: 000-10030

APPLE COMPUTER, INC.

(Exact name of Registrant as specified in its charter)

CALIFORNIA	**942404110**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
1 Infinite Loop **Cupertino, California**	**95014**
(Address of principal executive offices)	(Zip Code)

Registrant s telephone number, including area code: **(408) 996-1010**

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

Yes ý No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large accelerated filer ý Accelerated filer o Non-accelerated filer o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No ý

848,612,359 shares of common stock issued and outstanding as of January 25, 2006

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

APPLE COMPUTER, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (Unaudited)

(in millions, except share and per share amounts)

	Three Months Ended			
	December 31, 2005		December 25, 2004	
Net sales	$	5,749	$	3,490
Cost of sales (including stock-based compensation expense of $5 and $0, respectively)		4,185		2,494
Gross margin		1,564		996
Operating expenses:				
Research and development (including stock-based compensation expense of $15 and $2, respectively)		182		123
Selling, general, and administrative (including stock-based compensation expense of $24 and $8, respectively)		632		470
Total operating expenses		814		593
Operating income		750		403
Other income and expense		81		26
Income before provision for income taxes		831		429
Provision for income taxes		266		134
Net income	$	565	$	295
Earnings per common share:				
Basic	$	0.68	$	0.37
Diluted	$	0.65	$	0.35
Shares used in computing earnings per share (in thousands):				
Basic		830,781		789,032
Diluted		874,207		838,174

See accompanying notes to condensed consolidated financial statements.

APPLE COMPUTER, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS (Unaudited)

(in millions, except share amounts)

	December 31, 2005	September 24, 2005
ASSETS:		
Current assets:		
Cash and cash equivalents	$ 4,150	$ 3,491
Short-term investments	4,557	4,770
Accounts receivable, less allowances of $50 and $46, respectively	1,331	895
Inventories	244	165
Deferred tax assets	471	331
Other current assets	1,409	648
Total current assets	12,162	10,300
Property, plant and equipment, net	855	817
Goodwill	69	69
Acquired intangible assets	24	27
Other assets	1,071	338
Total assets	$ 14,181	$ 11,551
LIABILITIES AND SHAREHOLDERS EQUITY:		
Current liabilities:		
Accounts payable	$ 2,896	$ 1,779
Accrued expenses	2,164	1,705
Total current liabilities	5,060	3,484
Non-current liabilities	741	601
Total liabilities	5,801	4,085
Commitments and contingencies		
Shareholders equity:		
Common stock, no par value; 1,800,000,000 shares authorized; 845,617,174 and 835,019,364 shares issued and outstanding, respectively	3,815	3,521
Deferred stock compensation		(60)
Retained earnings	4,570	4,005
Accumulated other comprehensive income (loss)	(5)	
Total shareholders equity	8,380	7,466
Total liabilities and shareholders equity	$ 14,181	$ 11,551

See accompanying notes to condensed consolidated financial statements.

APPLE COMPUTER, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)

(in millions)

	Three Months Ended	
	December 31, 2005	**December 25, 2004**
Cash and cash equivalents, beginning of the period	$ 3,491	$ 2,969
Operating Activities:		
Net income	565	295
Adjustments to reconcile net income to cash generated by operating activities:		
Depreciation, amortization, and accretion	52	41
Stock-based compensation expense	44	10
Provision for (benefit from) deferred income taxes	70	(8)
Excess tax benefits from stock options		140
Loss on disposition of property, plant, and equipment		2
Changes in operating assets and liabilities:		
Accounts receivable	(436)	(91)
Inventories	(79)	(55)
Other current assets	(757)	(87)
Other assets	(771)	(27)
Accounts payable	1,117	286
Other liabilities	478	269
Cash generated by operating activities	283	775
Investing Activities:		
Purchases of short-term investments	(3,185)	(2,393)
Proceeds from maturities of short-term investments	3,396	777
Proceeds from sales of short-term investments		138
Purchases of property, plant, and equipment	(82)	(58)
Other	(36)	13
Cash generated by (used for) investing activities	93	(1,523)
Financing Activities:		
Proceeds from issuance of common stock	134	254
Excess tax benefits from stock-based compensation	149	
Cash generated by financing activities	283	254
Increase (decrease) in cash and cash equivalents	659	(494)
Cash and cash equivalents, end of the period	$ 4,150	$ 2,475
Supplemental cash flow disclosures:		
Cash paid for income taxes, net	$ 22	$ 37

See accompanying notes to condensed consolidated financial statements.

APPLE COMPUTER, INC.

Notes to Condensed Consolidated Financial Statements (Unaudited)

Note 1 Summary of Significant Accounting Policies

Apple Computer, Inc. and its subsidiaries (the Company) designs, manufactures, and markets personal computers and related software, services, peripherals, and networking solutions. The Company also designs, develops, and markets a line of portable digital music players along with related accessories and services including the online distribution of third-party music, audio books, music videos, short films, and television shows. The Company sells its products worldwide through its online stores, its own retail stores, its direct sales force, and third-party wholesalers, resellers, and value-added resellers. In addition to its own hardware, software, and peripheral products, the Company sells a variety of third-party hardware and software products through its online and retail stores. The Company sells to education, consumer, creative professional, business, and government customers.

Basis of Presentation and Preparation

The accompanying condensed consolidated financial statements include the accounts of the Company. Intercompany accounts and transactions have been eliminated. The preparation of these condensed consolidated financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in these condensed consolidated financial statements and accompanying notes. Actual results could differ materially from those estimates. Certain prior year amounts in the consolidated financial statements and notes thereto have been reclassified to conform to the current year presentation.

These condensed consolidated financial statements and accompanying notes should be read in conjunction with the Company s annual consolidated financial statements and the notes thereto for the fiscal year ended September 24, 2005, included in its Annual Report on Form 10-K for the year ended September 24, 2005 (the 2005 Form 10-K).

The Company s fiscal year is the 52 or 53-week period that ends on the last Saturday of September. The Company s first quarter of fiscal year 2006 contained 14 weeks and the first quarter of its fiscal year 2005 contained 13 weeks. The Company s fiscal year 2006 will end on September 30, 2006 and include 53 weeks while fiscal year 2005 included 52 weeks. Unless otherwise stated, references to particular years or quarters refer to the Company s fiscal years ended in September and the associated quarters of those fiscal years.

Common Stock Split

On February 28, 2005, the Company effected a two-for-one stock split to shareholders of record as of February 18, 2005. All share and per share information has been retroactively adjusted to reflect the stock split.

Software Development Costs

Research and development costs are expensed as incurred. Development costs of computer software to be sold, leased, or otherwise marketed are subject to capitalization beginning when a product s technological feasibility has been established and ending when a product is available for general release to customers pursuant to Statement of Financial Accounting Standards (SFAS) No. 86, *Computer Software to be Sold, Leased, or Otherwise Marketed*. In most instances, the Company s products are released soon after technological feasibility has been established. Therefore, costs incurred subsequent to achievement of technological feasibility are usually not significant, and generally all software development costs have been expensed.

In the fourth quarter of 2004, the Company began incurring substantial development costs associated with Mac OS X version 10.4 Tiger subsequent to achievement of technological feasibility as evidenced by public demonstration in August 2004 and the subsequent release of a developer beta version of the product. During the first quarter of 2005, the Company capitalized approximately $14.8 million of costs associated with the development of Tiger. In accordance with SFAS No. 86, amortization of this asset to cost of sales began in April 2005 when the Company began shipping Tiger and is being recognized on a straight-line basis over a three-year estimated useful life.

Stock-Based Compensation

On September 25, 2005, the Company adopted SFAS No. 123 (revised 2004) (SFAS No. 123R), *Share-Based Payment*, which addresses the accounting for stock-based payment transactions in which an enterprise receives employee services in exchange for (a) equity instruments of the enterprise or (b) liabilities that are based on the fair value of the enterprise s equity instruments or that may be settled by the issuance of such equity instruments. In January 2005, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin (SAB) No. 107, which provides supplemental implementation guidance for SFAS No. 123R. SFAS No. 123R eliminates the ability to account for stock-based compensation transactions using the intrinsic value method under Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*, and instead generally require that such transactions be accounted for using a fair-value-based method. The Company uses the Black-Scholes-Merton (BSM) option-pricing model to determine the fair-value of stock-based awards under SFAS No. 123R, consistent with that used for pro forma disclosures under SFAS No. 123, *Accounting for Stock-Based Compensation*. The Company has elected the modified prospective transition method as permitted by SFAS No. 123R and accordingly prior periods have not been restated to reflect the impact of SFAS No. 123R. The modified prospective transition method requires that stock-based compensation expense be recorded for all new and unvested stock options, restricted stock, restricted stock units, and employee stock purchase plan shares that are ultimately expected to vest as the requisite service is rendered beginning on September 25, 2005, the first day of the Company s fiscal year 2006. Stock-based compensation expense for awards granted prior to September 25, 2005 is based on the grant date fair-value as determined under the pro forma provisions of SFAS No. 123. The Company has recorded an incremental $32 million of stock-based compensation expense during the first quarter of 2006 as a result of the adoption of SFAS No. 123R. In accordance with SFAS No. 123R, beginning in the first quarter of 2006 the Company has presented excess tax benefits from the exercise of stock-based compensation awards as a financing activity in the Condensed Consolidated Statement of Cash Flows.

No stock-based compensation costs were capitalized as part of the cost of an asset as of December 31, 2005. The income tax benefit related to stock-based compensation expense was $14 million for the quarter ended December 31, 2005. As of December 31, 2005, $398 million of total unrecognized compensation cost related to stock options and restricted stock units are expected to be recognized over a weighted-average period of 2 years.

Prior to the adoption of SFAS No. 123R, the Company measured compensation expense for its employee stock-based compensation plans using the intrinsic value method prescribed by APB Opinion No. 25. The Company applied the disclosure provisions of SFAS No. 123 as amended by SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure* as if the fair-value-based method had been applied in measuring compensation expense. Under APB Opinion No. 25, when the exercise price of the Company s employee stock options was equal to the market price of the underlying stock on the date of the grant, no compensation expense was recognized.

The following table illustrates the effect on net income after taxes and net income per common share as if the Company had applied the fair value recognition provisions of SFAS No. 123 to stock-based compensation during the three-month period ended December 25, 2004 (in millions, except per share amounts):

		Three Months Ended 12/25/04
Net income - as reported	$	295
Add: Stock-based employee compensation expense included in reported net income, net of tax		9
Deduct: Stock-based employee compensation expense determined under the fair value based method for all awards, net of tax		(29)
Net income - pro forma	$	275
Net income per common share - as reported		
Basic	$	0.37

Diluted	$	0.35
Net income per common share - pro forma		
Basic	$	0.35
Diluted	$	0.33

Further information regarding stock-based compensation can be found in Note 6 of these Notes to Condensed Consolidated Financial Statements.

Earnings Per Share

Basic earnings per common share is computed by dividing income available to common shareholders by the weighted-average number of shares of common stock outstanding during the period. Diluted earnings per common share is computed by dividing income available to common shareholders by the weighted-average number of shares of common stock outstanding during the period increased to include the number of additional shares of common stock that would have been outstanding if the dilutive potential shares of common stock had been issued. The dilutive effect of outstanding options, restricted stock and restricted stock units is reflected in diluted earnings per share by application of the treasury stock method. Under the treasury stock method, an increase in the fair market value of the Company s common stock can result in a greater dilutive effect from outstanding options, restricted stock, and restricted stock units. Additionally, the exercise of employee stock options and the vesting of restricted stock and restricted stock units can result in a greater dilutive effect on earnings per share.

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

	Three Months Ended			
		12/31/05		**12/25/04**
Numerator (in millions):				
Net income	$	565	$	295
Denominator:				
Weighted-average shares outstanding, excluding unvested restricted stock		830,781		789,032
Effect of dilutive options, restricted stock units, and restricted stock		43,426		49,142
Denominator for diluted earnings per share		874,207		838,174
Basic earnings per share	$	0.68	$	0.37
Diluted earnings per share	$	0.65	$	0.35

Potentially dilutive securities, including stock options, restricted stock units, and restricted stock to acquire approximately 1.6 million and 1.7 million shares of common stock for the quarters ended December 31, 2005 and December 25, 2004, respectively, were excluded from the computation of diluted earnings per share for these periods because their effect would have been antidilutive.

Note 2 Financial Instruments

Cash, Cash Equivalents and Short-Term Investments

The following table summarizes the fair value of the Company s cash and available-for-sale securities held in its short-term investment portfolio, recorded as cash and cash equivalents or short-term investments as of December 31, 2005, and September 24, 2005 (in millions):

	12/31/05	9/24/05
Cash	$ 233	$ 127
U.S. Treasury and Agency securities	21	89
U.S. corporate securities	2,561	2,030
Foreign securities	1,335	1,245
Total cash equivalents	3,917	3,364
U.S. Treasury and Agency securities	296	216
U.S. corporate securities	3,220	3,662
Foreign securities	1,041	892
Total short-term investments	4,557	4,770
Total cash, cash equivalents, and short-term investments	$ 8,707	$ 8,261

The Company s U.S. corporate securities consist primarily of commercial paper, certificates of deposit, time deposits, and corporate debt securities. Foreign securities consist primarily of foreign commercial paper, certificates of deposit, and time deposits with foreign institutions, most of which are denominated in U.S. dollars. The Company had net unrealized losses totaling $6.7 million on its investment portfolio, the majority of which related to investments with stated maturities less than one year as of December 31, 2005 and net unrealized losses of $5.9 million on its investment portfolio, approximately half of which related to investments with stated maturities less than one year as of September 24, 2005.

As of December 31, 2005 and September 24, 2005, approximately $172 million and $287 million, respectively, of the Company s short-term investments had underlying maturities ranging from one to five years. The remaining short-term investments had maturities of three to 12 months.

Derivative Financial Instruments

The Company uses derivatives to partially offset its business exposure to foreign exchange and interest rate risk. Foreign currency forward and option contracts are used to offset the foreign exchange risk on certain existing assets and liabilities and to hedge the foreign exchange risk on expected future cash flows on certain forecasted revenue and cost of sales. From time to time, the Company enters into interest rate derivative agreements to modify the interest rate profile of certain investments and debt. The Company s accounting policies for these instruments are based on whether the instruments are designated as hedge or non-hedge instruments. The Company records all derivatives on the balance sheet at fair value. Derivatives that are not hedges are adjusted to fair value through earnings. If the derivative is a hedge, depending on the nature of the hedge, changes in fair value will either be offset against the change in fair value of the hedged assets, liabilities, or firm commitments through earnings, or recognized in other comprehensive income until the hedged item is recognized in earnings. As of December 31, 2005, the Company had a net deferred gain associated with cash flow hedges of approximately $5.5 million net of taxes, substantially all of which is expected to be reclassified to earnings by the end of the third quarter of fiscal 2006. As of the end of the first quarter of 2006, the general nature of the Company s risk management activities and the general nature and mix of the Company s derivative financial instruments have not changed materially from the end of 2005.

Foreign Exchange Risk Management

The Company may enter into foreign currency forward and option contracts with financial institutions to protect against foreign exchange risk associated with existing assets and liabilities, certain firmly committed transactions, forecasted future cash flows, and net investments in foreign subsidiaries. Generally, the Company s practice is to hedge a majority of its existing material foreign exchange transaction exposures. However, the Company may not hedge certain foreign exchange transaction exposures due to immateriality, prohibitive economic cost of hedging particular exposures, or limited availability of appropriate hedging instruments.

Note 3 Condensed Consolidated Financial Statement Details (in millions)

Other Current Assets

		12/31/05		9/24/05
Vendor non-trade receivables	$	1,082	$	417
Other current assets		327		231
Total other current assets	$	1,409	$	648

Property, Plant, and Equipment, Net

		12/31/05		9/24/05
Land and buildings	$	361	$	361
Machinery, equipment, and internal-use software		499		470
Office furniture and equipment		85		81
Leasehold improvements		602		569
		1,547		1,481
Accumulated depreciation and amortization		(692)		(664)
Total property, plant, and equipment, net	$	855	$	817

Other Assets

		12/31/05		9/24/05
Long-term NAND flash memory prepayments	$	750	$	
Non-current deferred tax assets		122		183
Capitalized software development costs, net		34		38
Other assets		165		117
Total other assets	$	1,071	$	338

Accrued Expenses

		12/31/05		9/24/05
Deferred revenue - current	$	630	$	501
Accrued marketing and distribution		204		221

Accrued compensation and employee benefits		164		167
Accrued warranty and related costs		247		188
Other current liabilities		919		628
Total accrued expenses	$	2,164	$	1,705

Non-Current Liabilities

		12/31/05		9/24/05
Deferred revenue - non-current	$	298	$	281
Deferred tax liabilities		430		308
Other non-current liabilities		13		12
Total non-current liabilities	$	741	$	601

Other Income and Expense

	Three Months Ended	
	12/31/05	12/25/04
Interest income	$ 88	$ 28
Other expense, net	(7)	(2)
Other income and expense	$ 81	$ 26

Note 4 Restructuring Actions

2004 Restructuring Actions

The Company recorded total restructuring charges of approximately $23 million during 2004, including approximately $14 million in severance costs, $5.5 million in asset impairments, and a $3.5 million charge for lease cancellations in conjunction with the vacating of a leased sales facility related to a European workforce reduction during the fourth quarter of 2004. Of the $23 million charge, $20.4 million had been utilized by the end of the first quarter of 2006, with the remaining $2.6 million consisting of $0.2 million for employee severance benefits and $2.4 million for lease cancellations. These actions will result in the termination of 452 positions, 450 of which had been terminated prior to the end of the first quarter of 2006.

The following table summarizes activity associated with restructuring actions initiated during 2004 (in millions):

	Employee Severance Benefits	Asset Impairments	Lease Cancellations	Totals
Total charge	$ 14.0	$ 5.5	$ 3.5	$ 23.0
Total spending through December 31, 2005	(12.5)		(1.1)	(13.6)
Total non-cash items		(5.2)		(5.2)
Adjustments	(1.3)	(0.3)		(1.6)
Accrual at December 31, 2005	$ 0.2	$	$ 2.4	$ 2.6

2003 Restructuring Actions

The Company recorded total restructuring charges of approximately $26.8 million during 2003, including approximately $7.4 million in severance costs, a $5.0 million charge to write off deferred compensation, $7.1 million in asset impairments and a $7.3 million charge for lease cancellations primarily related to the closure of the Company s Singapore manufacturing operations during the first quarter of 2003. Of the $26.8 million charge, all had been utilized by the end of the first quarter of 2006, except for approximately $1.6 million related to operating lease costs on abandoned facilities.

The following table summarizes activity associated with restructuring actions initiated during 2003 (in millions):

	Employee Severance Benefits	Deferred Compensation Write-off	Asset Impairments	Lease Cancellations	Totals
Total charge	$ 7.4	$ 5.0	$ 7.1	$ 7.3	$ 26.8
Total spending through December 31, 2005	(7.9)			(5.2)	(13.1)
Total non-cash items		(5.0)	(7.1)		(12.1)
Adjustments	0.5			(0.5)	
Accrual at December 31, 2005	$				