FLAGSTAR BANCORP INC
Form 10-Q
November 09, 2010

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2010

OR

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

Commission File Number: 001-16577

(Exact name of registrant as specified in its charter).

Michigan	**38-3150651**
(State or other jurisdiction of Incorporation or organization)	(I.R.S. Employer Identification No.)
5151 Corporate Drive, Troy, Michigan	**48098-2639**
(Address of principal executive offices)	(Zip code)

(248) 312-2000

(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past ninety days.
Yes þ No o.

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).
Yes o No o.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o	Accelerated filer o	Non-accelerated filer þ (Do not check if smaller reporting company)	Smaller reporting company 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 þ.

As of November 8, 2010, 269,278,468 shares of the registrant s common stock, $0.01 par value, were issued and outstanding.

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FORWARD LOOKING STATEMENTS

This report contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, as amended. Forward-looking statements, by their nature, involve estimates, projections, goals, forecasts, assumptions, risks and uncertainties that could cause actual results or outcomes to differ materially from those expressed in a forward-looking statement. Examples of forward-looking statements include statements regarding our expectations, beliefs, plans, goals, objectives and future financial or other performance. Words such as expects, anticipates, intends, plans, believes, seeks, estimates and variations of such words and similar expressions are to identify such forward-looking statements. Any forward-looking statement speaks only as of the date on which it is made. Except to fulfill our obligations under the U.S. securities laws, we undertake no obligation to update any such statement to reflect events or circumstances after the date on which it is made.

There are a number of important factors that could cause future results to differ materially from historical performance and these forward-looking statements. Factors that might cause such a difference include:

General business and economic conditions, including unemployment rates, movements in interest rates, the slope of the yield curve, any increase in mortgage fraud and other criminal activity and the potential decline of housing prices in certain geographic markets, may significantly affect our business activities, loan losses, reserves and earnings;

Volatile interest rates that impact, amongst other things, (i) the mortgage banking business, (ii) our ability to originate loans and sell assets at a profit, (iii) prepayment speeds and (iv) our cost of funds, could adversely affect earnings, growth opportunities and our ability to pay dividends to stockholders;

Our ability to raise additional capital;

Competitive factors for loans could negatively impact gain on loan sale margins;

Competition from banking and non-banking companies for deposits and loans can affect our growth opportunities, earnings, gain on sale margins and our market share;

Changes in the regulation of financial services companies and government-sponsored housing enterprises, and in particular, declines in the liquidity of the mortgage loan secondary market, could adversely affect business;

Changes in regulatory capital requirements or an inability to achieve desired capital ratios could adversely affect our growth and earnings opportunities and our ability to originate certain types of loans, as well as our ability to sell certain types of assets for fair market value;

Actions of mortgage loan purchasers, guarantors and insurers regarding repurchase and indemnity demands and uncertainty related to foreclosure procedures could adversely affect business activities and earnings;

Factors concerning the implementation of proposed enhancements could result in slower implementation times than we anticipate and negate any competitive advantage that we may enjoy; and

Financial services reform legislation recently enacted into law by the President will, among other things, eliminate the Office of Thrift Supervision, tighten capital standards, create a new Bureau of Consumer Financial Protection and result in new laws and regulations that are expected to increase our costs of operations.

All of the above factors are difficult to predict, contain uncertainties that may materially affect actual results, and may be beyond our control. New factors emerge from time to time, and it is not possible for our management to predict all such factors or to assess the effect of each such factor on our business.

Please also refer to Item 1A. Risk Factors to Part II of this report, Item 1A to Part I of our Annual Report on Form 10-K for the fiscal year ended December 31, 2009 and Item 1A to Part II of our Quarterly Reports on Form 10-Q for the quarters ended June 30, 2010 and March 31, 2010, which are incorporated by reference herein, for further information on these and other factors affecting us.

Although we believe that the assumptions underlying the forward-looking statements contained herein are reasonable, any of the assumptions could be inaccurate, and therefore any of these statements included herein may prove to be inaccurate. In light of the significant uncertainties inherent in the forward-looking statements included herein, the inclusion of such information should not be regarded as a representation by us or any other person that the results or conditions described in such statements or our objectives and plans will be achieved.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

The consolidated financial statements of the Company are as follows:

Consolidated Statements of Financial Condition September 30, 2010 (unaudited) and December 31, 2009	5
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Flagstar Bancorp, Inc.
Consolidated Statements of Financial Condition
(In thousands, except share data)

	September 30, 2010 (Unaudited)	December 31, 2009
Assets		
Cash and cash items	$ 50,422	$ 73,019
Interest-bearing deposits	962,711	1,009,470
Cash and cash equivalents	1,013,133	1,082,489
Securities classified as trading	161,000	330,267
Securities classified as available for sale	503,568	605,621
Other investments restricted		15,601
Loans available for sale ($1,780,486 and $1,937,171 at fair value at September 30, 2010 and December 31, 2009, respectively)	1,943,096	1,970,104
Loans held for investment ($35,994 and $11,287 at fair value at September 30, 2010 and December 31, 2009, respectively)	7,312,226	7,714,308
Less: allowance for loan losses	(474,000)	(524,000)
Loans held for investment, net	6,838,226	7,190,308
Total interest-earning assets	10,408,601	11,121,371
Accrued interest receivable	37,898	44,941
Repossessed assets, net	198,585	176,968
Federal Home Loan Bank stock	373,443	373,443
Premises and equipment, net	233,235	239,318
Mortgage servicing rights at fair value	447,023	649,133
Mortgage servicing rights, net		3,241
Other assets	2,087,366	1,331,897
Total assets	$ 13,836,573	$ 14,013,331
Liabilities and Stockholders Equity		
Deposits	$ 8,561,943	$ 8,778,469
Federal Home Loan Bank advances	3,400,000	3,900,000
Security repurchase agreements		108,000
Long term debt	248,610	300,182
Total interest-bearing liabilities	12,210,553	13,086,651
Accrued interest payable	18,338	26,086
Secondary market reserve	77,500	66,000
Other liabilities	469,453	237,870
Total liabilities	12,775,844	13,416,607

Commitments and contingencies 21		
Stockholders Equity		
Preferred stock $0.01 par value, liquidation value $1,000 per share, 25,000,000 shares authorized; 266,657 issued and outstanding at September 30, 2010 and December 31, 2009, respectively	3	3
Common stock $0.01 par value, 300,000,000 shares authorized; 153,512,990 and 46,877,067 shares issued and outstanding at September 30, 2010 and December 31, 2009, respectively	1,535	469
Additional paid in capital preferred	247,837	243,778
Additional paid in capital common	1,079,042	447,449
Accumulated other comprehensive loss	(19,484)	(48,263)
Accumulated deficit	(248,204)	(46,712)
Total stockholders equity	1,060,729	596,724
Total liabilities and stockholders equity	$ 13,836,573	$ 14,013,331

The accompanying notes are an integral part of these consolidated financial statements.

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Flagstar Bancorp, Inc.
Consolidated Statements of Operations
(In thousands, except per share data)

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2010	2009	2010	2009
	(Unaudited)			
Interest Income				
Loans	$111,744	$ 136,849	$ 330,745	$ 452,233
Securities classified as available for sale or trading	10,968	29,738	47,069	85,873
Interest-earning deposits	504	517	1,628	1,799
Other	1	3	3	28
Total interest income	123,217	167,107	379,445	539,933
Interest Expense				
Deposits	40,270	58,352	123,677	192,248
FHLB advances	39,816	56,116	123,755	170,210
Security repurchase agreements		1,178	2,750	3,497
Long term debt and other	2,017	3,867	8,060	9,638
Total interest expense	82,103	119,513	258,242	375,593
Net interest income	41,114	47,594	121,203	164,340
Provision for loan losses	51,399	125,544	200,978	409,420
Net interest expense after provision for loan losses	(10,285)	(77,950)	(79,775)	(245,080)
Non-Interest Income				
Loan fees and charges	24,365	29,422	60,930	97,366
Deposit fees and charges	7,585	8,438	24,796	23,655
Loan administration	12,924	(30,293)	(15,590)	(20,240)
Gain on trading securities	10,354	21,714	76,702	6,377
Loss on residual and transferors interest	(4,665)	(50,689)	(11,660)	(66,625)
Net gain on loan sales	103,211	104,416	220,034	404,773
Net loss on sales of mortgage servicing rights	(1,195)	(1,319)	(4,674)	(3,945)
Net gain on securities available for sale			6,689	
Total other-than-temporary impairment gain (loss)		34,100	35,200	(69,533)
Less: portion of other-than-temporary impairment gains (losses) recognized in other comprehensive income before taxes		36,975	38,877	(49,089)
Net impairment loss recognized in earnings		(2,875)	(3,677)	(20,444)
Other fees and charges	(7,691)	(12,582)	(36,333)	(29,189)

Total non-interest income	144,888	66,232	317,217	391,728
Non-Interest Expense				
Compensation, commissions and benefits	59,817	68,611	171,944	232,038
Occupancy and equipment	15,757	17,175	47,670	53,553
Asset resolution	34,233	26,811	96,245	69,660
Federal insurance premiums	8,522	7,666	29,209	28,514
Other taxes	1,964	12,944	3,660	15,049
Warrant (income) expense	(1,405)	3,556	(3,664)	27,561
Loss on extinguishment of debt	11,855		20,826	
General and administrative	21,756	30,143	58,985	95,017
Total non-interest expense	152,499	166,906	424,875	521,392
Loss before federal income taxes	(17,896)	(178,624)	(187,433)	(374,744)
Provision for federal income taxes		114,965		55,008
Net Loss	(17,896)	(293,589)	(187,433)	(429,752)
Preferred stock dividend/accretion	(4,690)	(4,623)	(14,059)	(12,464)
Net loss applicable to common stock	$ (22,586)	$ (298,212)	$ (201,492)	$ (442,216)
Loss per share				
Basic	$ (0.15)	$ (6.36)	$ (1.57)	$ (16.58)
Diluted	$ (0.15)	$ (6.36)	$ (1.57)	$ (16.58)

The accompanying notes are an integral part of these consolidated financial statements.

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Flagstar Bancorp, Inc.
Consolidated Statements of Stockholders Equity and Comprehensive Income (Loss)
(In thousands)

	Preferred Stock	Common Stock	Additional Paid in Capital - Preferred	Additional Paid in Capital - Common	Accumulated Other Comprehensive Income (Loss)	Retained Earnings (Accumulated Deficit)	Total Stockholders Equity
Balance at December 31, 2008	$	$ 84	$	$ 119,776	$ (81,742)	$ 434,175	$ 472,293
(Unaudited)							
Net loss						(429,752)	(429,752)
Reclassification of loss on securities available for sale due to other-than- temporary impairment					13,289		13,289
Change in net unrealized loss on securities available for sale					53,682		53,682
Total comprehensive loss							(362,781)
Cumulative effect for adoption of new guidance for other-than-temporary impairments					(32,914)	32,914	
Issuance of preferred stock	6		507,488				507,494
Conversion of preferred stock	(3)	375	(268,574)	268,202			
Issuance of common stock to management		7		5,314			5,321
Reclassification of Treasury Warrants				49,673			49,673
Issuance of common stock for exercise of May Warrants		3		4,373			4,376
Restricted stock issued				(45)			(45)
Dividends on preferred stock						(8,927)	(8,927)
Accretion of preferred stock			3,537			(3,537)	
				658			658

Stock-based compensation							
Tax effect from stock-based compensation				(465)			(465)
Balance at September 30, 2009	$ 3	$ 469	$ 242,451	$ 447,486	$ (47,685)	$ 24,873	$ 667,597
Balance at December 31, 2009	$	$ 469	$ 243,778	$ 447,449	$ (48,263)	$ (46,712)	$ 596,724
(Unaudited)							
Net loss						(187,433)	(187,433)
Reclassification of gain on sale of securities available for sale					(6,689)		(6,689)
Reclassification of loss on securities available for sale due to other-than- temporary impairment					3,677		3,677
Change in net unrealized loss on securities available for sale					31,791		31,791
Total comprehensive loss							(158,654)
Issuance of common stock		1,061		626,441			627,502
Restricted stock issued				(12)			(12)
Dividends on preferred stock						(10,000)	(10,000)
Accretion of preferred stock			4,059			(4,059)	
Stock-based compensation		5		5,164			5,169
Tax effect from stock-based compensation							
Balance at September 30, 2010	$	$ 1,535	$ 247,837	$ 1,079,042	$ (19,484)	$ (248.204)	$ 1,060,729

The accompanying notes are an integral part of these consolidated financial statements.

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Flagstar Bancorp, Inc.
Consolidated Statements of Cash Flows
(In thousands)

	For the Nine Months Ended September 30,	
	2010	2009
	(Unaudited)	
Operating Activities		
Net loss	$ (187,433)	$ (429,752)
Adjustments to net loss to net cash used in operating activities		
Provision for loan losses	200,978	409,420
Depreciation and amortization	13,748	17,075
Increase in valuation allowance in mortgage servicing rights	961	3,774
Loss on fair value of residential mortgage servicing rights net of hedging gains (losses)	231,923	91,078
Stock-based compensation expense	5,169	658
Gain on interest rate swap	(728)	(326)
Net loss on the sale of assets	5,908	1,241
Net gain on loan sales	(220,034)	(404,773)
Net loss on sales of mortgage servicing rights	4,674	3,945
Net gain on sale of securities classified as available for sale	(6,689)	
Other than temporary impairment losses on securities classified as available for sale	3,677	20,444
Net gain on trading securities	(76,702)	(6,377)
Net loss on residual and transferor interest	11,660	66,625
Proceeds from sales of loans available for sale	18,019,645	24,267,675
Origination and repurchase of mortgage loans available for sale, net of principal repayments	(18,101,403)	(25,236,411)
Purchase of trading securities	(899,011)	(744,946)
Proceeds from sales of trading securities	1,143,279	1,079,716
Decrease in accrued interest receivable	7,043	5,350
Increase in other assets	(757,727)	(533,774)
Decrease in accrued interest payable	(7,748)	(11,223)
Net tax effect of stock grants issued		465
Increase in liability for checks issued	7,547	9,701
Decrease in federal income taxes payable		(36,527)
Increase in other liabilities	145,914	62,936
Net cash used in operating activities	(455,349)	(1,364,006)
Investing Activities		
Net change in other investments	15,601	(6,987)
Proceeds from the sale of investment securities available for sale	418,178	
Net (purchase) repayment of investment securities available for sale	(124,815)	46,487
Proceeds from sales of portfolio loans	(65,077)	9,184
Origination of portfolio loans, net of principal repayments	25,545	437,396
Investment in unconsolidated subsidiary		1,547
Proceeds from the disposition of repossessed assets	169,063	178,539

Acquisitions of premises and equipment, net of proceeds	(7,287)	(9,692)
Proceeds from the sale of mortgage servicing rights	124,729	119,815
Net cash provided by investing activities	555,937	776,289
Financing Activities		
Net (decrease) increase in deposit accounts	(216,526)	692,963
Net decrease in Federal Home Loan Bank advances	(500,000)	(400,000)
Payment on long-term debt	(25)	(25)
Net decrease in security repurchase agreements	(108,000)	
Net receipt of payments of loans serviced for others	80,417	24,345
Net receipt of escrow payments	6,688	6,032
Net tax benefit for stock grants issued		(465)
Dividends paid to preferred stockholders	(10,000)	(7,222)
Issuance of junior subordinated debt		50,000
Issuance of preferred stock		544,365
Issuance of common stock	577,502	6,696
Net cash (used in) provided by financing activities	(169,944)	916,689
Net (decrease) increase in cash and cash equivalents	(69,356)	328,972
Beginning cash and cash equivalents	$ 1,082,489	$ 506,905
Ending cash and cash equivalents	$ 1,013,133	$ 835,877

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Flagstar Bancorp, Inc.
Consolidated Statements of Cash Flows
(In thousands)

	For the Nine Months Ended September 30,	
	2010	**2009**
Supplemental Disclosure of Cash Flow Information:		
Loans held for investment transferred to repossessed assets	$ 447,445	$ 492,798
Total interest payments made on deposits and other borrowings	$ 265,990	$ 386,816
Federal income taxes paid	$ 541	$ 1,510
Reclassification of mortgage loans originated for investment to mortgage loans available for sale	$ 146,114	$ 32,987
Reclassification of mortgage loans originated available for sale to held for investment loans	$ 81,037	$ 42,171
Recharacterization of mortgage loans available for sale to investment securities available for sale	$ 159,422	$ 314,625
Mortgage servicing rights resulting from sale or securitization of loans	$ 157,177	$ 267,960
Conversion of mandatory convertible participating voting preferred stock to common stock	$	$ 271,577
Conversion of convertible trust securities	$ 50,000	$

The accompanying notes are an integral part of these consolidated financial statements.

Flagstar Bancorp, Inc.
Notes to the Consolidated Financial Statements (Unaudited)

Note 1 Nature of Business

Flagstar Bancorp, Inc. (Flagstar or the Company), is the holding company for its principal subsidiary, Flagstar Bank, FSB (the Bank), a federally chartered stock savings bank founded in 1987. With $13.8 billion in assets at September 30, 2010, Flagstar is the largest insured depository institution headquartered in Michigan. Unless otherwise specified, references herein to the Company shall include the business operations of the Company and the Bank.

The Company s principal business is obtaining funds in the form of deposits and wholesale borrowings and investing those funds in single-family mortgages and other types of loans. The Company s primary lending activity is the acquisition or origination of single-family mortgage loans. The Company may also originate consumer loans, commercial real estate loans and non-real estate commercial loans. The Company services a significant volume of residential mortgage loans for others.

The Company sells or securitizes most of the mortgage loans that it originates and generally retains the right to service the mortgage loans that it sells. These mortgage servicing rights (MSRs) are occasionally sold by the Company in transactions separate from the sale of the underlying mortgages. The Company may also invest in a significant amount of its loan production to enhance the Company s leverage and to receive the interest spread between earning assets and paying liabilities.

The Bank is a member of the Federal Home Loan Bank (FHLB) of Indianapolis and is subject to regulation, examination and supervision by the Office of Thrift Supervision (including any successors thereto OTS) and the Federal Deposit Insurance Corporation (FDIC). The Bank s deposits are insured by the FDIC through the Deposit Insurance Fund (DIF).

Note 2 Basis of Presentation

The accompanying unaudited consolidated financial statements include the accounts of the Company and its consolidated subsidiaries. All significant intercompany balances and transactions have been eliminated. The Company s 10 trust subsidiaries and four securitization trusts are considered variable interest entities and are not consolidated in the Company s consolidated financial statements because the Company is not the primary beneficiary of those entities. Prior to January 1, 2010, the securitization trusts were not consolidated in the Company s consolidated financial statements because they were qualified special purpose entities under FASB ASC Topic 860, *Transfers and Servicing*. The concept of the special purpose entity was eliminated from ASC Topic 860 effective January 1, 2010. In addition, certain prior period amounts have been reclassified to conform to the current period presentation.

The unaudited consolidated financial statements of the Company have been prepared in accordance with generally accepted accounting principles for interim information and in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X as promulgated by the Securities and Exchange Commission (the SEC). Accordingly, they do not include all the information and footnotes required by accounting principles generally accepted in the United States of America (U.S. GAAP) for complete financial statements. The accompanying interim financial statements are unaudited; however, in the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. The results of operations for the nine month period ended September 30, 2010, are not necessarily indicative of the results that may be expected for the year ending December 31, 2010. For further information, reference should be made to the consolidated financial statements and footnotes thereto included in the Company s Annual Report on Form 10-K for the year ended December 31, 2009, which are available on the Company s Investor Relations web page, at **www.flagstar.com**, and on the SEC website, at **www.sec.gov**.

Note 3 Recent Developments

Equity Offerings

On November 2, 2010, the Company completed a registered offering of 14,192,250 shares of its Mandatorily Convertible Non-Cumulative Perpetual Preferred Stock Series D (the Convertible Preferred Stock), which included 692,250 shares issued pursuant to the underwriter s over-allotment option, and a registered offering of 115,655,000 shares of its common stock, par value $0.01 per share (Common Stock), which included 5,655,000 shares issued

pursuant to the underwriter s over-allotment option. The public offering price of the Convertible Preferred Stock and the Common Stock was $20.00 and $1.00 per share, respectively. Upon stockholder approval of an amendment to increase the number of authorized shares of Common Stock from 300,000,000 shares to 700,000,000 shares, each share of Convertible Preferred Stock will be automatically converted into 20 shares of Common Stock, based on a conversion price of $1.00 per share of Common Stock. MP Thrift Investments, L.P. (MP Thrift), participated in the registered offerings and

purchased 8,884,637 shares of Convertible Preferred Stock and 72,307,263 shares of Common Stock at the offering price. The offerings resulted in aggregate net proceeds to the Company of approximately $385.8 million, after deducting underwriting fees and offering expenses.

Asset Sale

On November 2, 2010, the Company announced that it had entered into an agreement to sell approximately $474 million of non-insured non-performing residential first mortgage loans and will reclassify an additional $86 million in residential non-performing loans as available for sale.

The Company expects to receive approximately $209 million, or 44% of book value before allocated allowance for loan losses, for the $474 million of non-performing loans. Approximately $133 million of the allowance for loan losses is currently allocated to the $474 million of non-performing loans. In aggregate, the Company expects a loss of approximately $132 million on the transaction, which is expected to close in the fourth quarter 2010. The Company also expects that the carrying value of the remaining residential non-performing (excluding those insured by the Federal Housing Administration (FHA) or U.S. Department of Veterans Affairs (VA) loans will be reclassified to available for sale on the Company s balance sheet and reflect fair value based upon the value at which the above-mentioned transaction is completed.

Note 4 Supervisory Agreements

On January 27, 2010, the Company and the Bank each entered into respective supervisory agreements with the OTS (collectively, the Supervisory Agreements). The Company and the Bank have taken numerous steps to comply with, and intend to comply in the future with, all of the requirements of the Supervisory Agreements, and do not believe that the Supervisory Agreements will materially constrain management s ability to implement its business plan. The Supervisory Agreements will remain in effect until terminated, modified, or suspended in writing by the OTS, and the failure to comply with the Supervisory Agreements could result in the initiation of further enforcement action by the OTS, including the imposition of further operating restrictions and result in additional enforcement actions against the Company.

Note 5 Recent Accounting Developments

ASU No. 2010-20, Receivables (Topic 310): Disclosure about Credit Quality of Financing Receivables and Allowance For Credit Losses. This guidance requires an entity to provide disclosures that facilitate the evaluation of the nature of credit risk inherent in its portfolio of financing receivables; how that risk is analyzed and assessed in determining the allowance for credit losses; and the changes and reasons for those changes in the allowance for credit losses. To achieve those objectives, disclosures on a disaggregated basis must be provided on two defined levels: (1) portfolio segment; and (2) class of financing receivable. This guidance makes changes to existing disclosure requirements and includes additional disclosure requirements relating to financing receivables. Short-term accounts receivable, receivables measured at fair value or lower of cost or fair value and debt securities are exempt from this guidance. The disclosures related to period-end information are required to be provided in all interim and annual periods ending on or after December 15, 2010. Disclosures of activity that occurs during the reporting period are required in interim and annual periods beginning on or after December 15, 2010. The provisions of this guidance are not expected to have a significant impact on the Company s consolidated financial condition, results of operations or liquidity.

Note 6 Fair Value Accounting

The Company adheres to guidance related to fair value measurements and additional guidance for financial instruments. This guidance establishes a framework for measuring fair value and prescribes disclosures about fair value measurements. The guidance also establishes a uniform definition of fair value. The definition of fair value under this guidance is market-based as opposed to Company-specific and includes the following:

Defines fair value as the price that would be received to sell an asset or paid to transfer a liability, in either case through an orderly transaction between market participants at a measurement date, and establishes a framework for measuring fair value;

Establishes a three-level hierarchy for fair value measurements based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date;

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Nullifies previous fair value guidance, which required the deferral of profit at inception of a transaction involving a derivative financial instrument in the absence of observable data supporting the valuation technique; and

Eliminates large position discounts for financial instruments quoted in active markets and requires consideration of the company s creditworthiness when valuing liabilities.

The accounting guidance for financial instruments provides an option to elect fair value as an alternative measurement for selected financial assets, financial liabilities, unrecognized Company commitments and written loan commitments not previously recorded at fair value. In accordance with the provisions of this guidance, the Company applied the fair value option to certain non-investment grade residual securities that arose from private-label securitizations. Accordingly, these residual securities are classified as trading securities. As of September 30, 2010, the Company s residuals interests were deemed to have no value.

The Company applies the fair value measurement method for residential MSRs under guidance related to servicing assets and liabilities. Management applies the fair value measurement method of accounting for residential MSRs to be consistent with the fair value accounting method required for its risk management strategy to economically hedge the fair value of these assets. Changes in the fair value of MSRs, as well as changes in fair value of the related derivative and other hedging instruments, are recognized each period within the combination of loan administration income (loss) on the consolidated statement of operations and in gain (loss) on trading securities, to the extent such instruments are held on the balance sheet.

Effective January 1, 2009, the Company elected the fair value option for the majority of its loans available for sale in accordance with the accounting guidance for financial instruments. Only loans available for sale originated subsequent to January 1, 2009 were affected. Prior to the Company s fair value election, loans available for sale were carried at the lower of aggregate cost or estimated fair value; therefore, any increase in fair value to such loans was not realized until such loans were sold. See Note 8, Loans Available for Sale, for further information.

Determination of Fair Value

The Company has an established process for determining fair values. Fair value is based upon quoted market prices, where available. If listed prices or quotes are not available, fair value is based upon internally developed models that use primarily market-based or independently-sourced market parameters, including interest rate yield curves and option volatilities. Valuation adjustments may be made to ensure that financial instruments are recorded at fair value. These adjustments include amounts to reflect counterparty credit quality, creditworthiness, liquidity and unobservable parameters that are applied consistently over time. Any changes to the valuation methodology are reviewed by management to determine appropriateness of the changes. As markets develop and the pricing for certain products becomes more transparent, the Company expects to continue to refine its valuation methodologies.

The methods described above may produce a fair value estimate that may not be indicative of net realizable value or reflective of future fair values. Furthermore, while the Company believes its valuation methods are appropriate and consistent with other market participants, the use of different methodologies or assumptions by other market participants to determine the fair value of certain financial instruments could result in different estimates of fair values of the same financial instruments as held by the Company at the reporting date.

Valuation Hierarchy

The accounting guidance for fair value measurements and disclosures establishes a three-level valuation hierarchy for disclosure of fair value measurements. The valuation hierarchy favors the transparency of inputs to the valuation of an asset or liability as of the measurement date and thereby favors use of Level 1 if appropriate information is available, and otherwise Level 2 and finally Level 3 if Level 2 input is not available. The three levels are defined as follows.

Level 1 Fair value is based upon quoted prices (unadjusted) for identical assets or liabilities in active markets in which the Company may participate.

Level 2 Fair value is based upon quoted prices for similar (i.e., not identical) assets and liabilities in active markets, and other inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.

Level 3 Fair value is based upon financial models using primarily unobservable inputs.

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A financial instrument s categorization within the valuation hierarchy is based upon the lowest level of input within the valuation hierarchy that is significant to the fair value measurement.

The following is a description of the valuation methodologies used by the Company for instruments measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy.

Assets

Securities classified as trading. These securities are comprised of U.S. government sponsored agency mortgage-backed securities, U.S. Department of the Treasury (U.S. Treasury) bonds and non-investment grade residual securities that arose from private-label securitizations of the Company. The U.S. government sponsored agency mortgage-backed securities and U.S. Treasury bonds trade in an active, open market with readily observable prices and are therefore classified within the Level 1 valuation hierarchy. The non-investment grade residual securities do not trade in an active, open market with readily observable prices and are therefore classified within the Level 3 valuation hierarchy. Under Level 3, the fair value of residual securities is determined by discounting estimated net future cash flows using expected prepayment rates and discount rates that approximate current market rates. Estimated net future cash flows include assumptions related to expected credit losses on these securities. The Company maintains a model that evaluates the default rate and severity of loss on the residual securities collateral, considering such factors as loss experience, delinquencies, loan-to-value ratios, borrower credit scores and property type. See Note 11, Private Label Securitization Activity, for the key assumptions used in the residual interest valuation process. At September 30, 2010, the Company s residual interests were deemed to have no value.

Securities classified as available for sale. These securities are comprised of U.S. government sponsored agency mortgage-backed securities and collateralized mortgage obligations (CMOs). Where quoted prices for securities are available in an active market, those securities are classified within Level 1 of the valuation hierarchy. If such quoted market prices are not available, then fair values are estimated using pricing models, quoted prices of securities with similar characteristics, or discounted cash flows. Due to illiquidity in the markets, the Company determined the fair value of certain non-agency securities using internal valuation models and therefore classified them within the Level 3 valuation hierarchy as these models utilize significant inputs which are unobservable.

Other investments-restricted. Other investments are primarily comprised of various mutual fund holdings. These mutual funds trade in an active market and quoted prices are available. Other investments are classified within Level 1 of the valuation hierarchy. At September 30, 2010, no such investments were outstanding.

Loans available for sale. At September 30, 2010, the majority of the Company s loans originated and classified as available for sale were reported at fair value and classified as Level 2. The Company estimates the fair value of mortgage loans based on quoted market prices for securities backed by similar types of loans. Otherwise, the fair value of loans is estimated using discounted cash flows based upon management s best estimate of market interest rates for similar collateral. The Company generally estimated the fair value of mortgage loans based on quoted market prices for securities backed by similar types of loans. Where quoted market prices were available, such market prices were utilized as estimates for fair values. Otherwise, the fair values of loans were estimated by discounting estimated cash flows using management s best estimate of market interest rates, prepayment speeds and loss assumptions for similar collateral. At September 30, 2010, the Company continued to have a relatively small number of loans which were originated prior to the fair value election and accounted for at lower of cost or market. Loans as to which the Company has the unilateral right to repurchase from certain securitization transactions, but has not yet repurchased, are classified as available for sale and accounted for at historical cost, based on current unpaid principal balance.

Loans held for investment. The Company generally does not record these loans at fair value on a recurring basis. However, from time to time, a loan is considered impaired and an allowance for loan losses is established. Loans are considered impaired if it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement. Once a loan is identified as impaired, the fair value of the impaired loan is estimated using one of several methods, including collateral value, market value of similar debt, enterprise value and liquidation value or discounted cash flows. Impaired loans do not require an allowance if the fair value of the expected repayments or collateral exceed the recorded investments in such loans. At September 30, 2010, substantially all of the impaired loans were evaluated based on the fair value of the collateral rather than on discounted cash flows. If the fair value of collateral is used to establish an allowance, the underlying impaired loan must be assigned a classification in the fair value hierarchy. To the extent the fair value of the collateral is based on an observable market price or a

current appraised value, the Company records the impaired loan as a nonrecurring Level 2 valuation.

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Repossessed assets. Loans on which the underlying collateral has been repossessed are adjusted to fair value less costs to sell upon transfer to repossessed assets. Subsequently, repossessed assets are carried at the lower of carrying value or fair value, less anticipated marketing and selling costs. Fair value is based upon independent market prices, appraised values of the collateral or management s estimation of the value of the collateral. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company records the repossessed asset as a nonrecurring Level 2 valuation.

Mortgage Servicing Rights. The Company has obligations to service residential first mortgage loans, and consumer loans (i.e., home equity lines of credit (HELOCs) and second mortgage loans). Residential MSRs are accounted for at fair value on a recurring basis, while servicing rights associated with consumer loans are carried at amortized cost and are periodically evaluated for impairment. At September 30, 2010, the Company no longer had any MSR s associated with consumer loans.

Residential Mortgage Servicing Rights. Management believes that the current market for residential mortgage servicing rights is not sufficiently liquid to provide participants with quoted market prices. Therefore, the Company uses an option-adjusted spread valuation approach to determine the fair value of residential MSRs. This approach consists of projecting servicing cash flows under multiple interest rate scenarios and discounting these cash flows using risk-adjusted discount rates. The key assumptions used in the valuation of residential MSRs include mortgage prepayment speeds and discount rates. Management periodically obtains third-party valuations of the residential MSR portfolio to assess the reasonableness of the fair value calculated by its internal valuation model. Due to the nature of the valuation inputs, residential MSRs are classified within Level 3 of the valuation hierarchy. See Note 12, Mortgage Servicing Rights, for the key assumptions used in the residential MSR valuation process.

Consumer Loan Servicing Rights. Consumer servicing assets are subject to periodic impairment testing. A valuation model, which utilizes a discounted cash flow analysis using interest rates and prepayment speed assumptions currently quoted for comparable instruments and a discount rate determined by management, is used in the completion of impairment testing. If the valuation model reflects a value less than the carrying value, consumer servicing assets are adjusted to fair value through a valuation allowance as determined by the model. As such, the Company classifies consumer servicing assets subject to nonrecurring fair value adjustments as Level 3 valuations.

Derivative Financial Instruments. Certain classes of derivative contracts are listed on an exchange and are actively traded, and they are therefore classified within Level 1 of the valuation hierarchy. These include U.S. Treasury futures, U.S. Treasury options and interest rate swaps. The Company s forward loan sale commitments may be valued based on quoted prices for similar assets in an active market with inputs that are observable and are classified within Level 2 of the valuation hierarchy. Rate lock commitments are valued using internal models with significant unobservable market parameters and therefore are classified within Level 3 of the valuation hierarchy.

Liabilities

Warrants. Warrant liabilities are valued using a binomial lattice model and are classified within Level 2 of the valuation hierarchy. Significant assumptions include expected volatility, a risk free rate and an expected life.

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Assets and liabilities measured at fair value on a recurring basis

The following tables presents the financial instruments carried at fair value as of September 30, 2010 and December 31, 2009, by caption on the Consolidated Statement of Financial Condition and by the valuation hierarchy (as described above):

September 30, 2010	Level 1	Level 2	Level 3	Total Carrying Value in the Consolidated Statement of Financial Condition
		(Dollars in thousands)		
Securities classified as trading:				
Mortgage-backed securities	$161,000	$	$	$ 161,000
Total securities classified as trading	161,000			161,000
Securities classified as available for sale	8,461		495,107	503,568
Loans available for sale		1,780,486		1,780,486
Loans held for investment		35,994		35,994
Residential mortgage servicing rights			447,023	447,023
Derivative assets:				
Rate lock commitments			50,540	50,540
Agency forwards	5,096			5,096
U.S. Treasury futures				
Total derivative assets	5,096		50,540	55,636
Total assets at fair value	174,557	1,816,480	992,670	2,983,707
Derivative liabilities:				
Interest rate swaps	19			19
U.S. Treasury futures	2,649			2,649
Forward agency and loan sales		19,117		19,117
Total derivative liabilities	2,668	19,117		21,785
Warrant liabilities		1,447		1,447
Total liabilities at fair value	2,668	20,564		23,232
Net assets and liabilities at fair value	$171,889	$1,795,916	$992,670	$ 2,960,475

December 31, 2009	Level 1	Level 2	Level 3	Total Carrying Value in the Consolidated Statement of Financial Condition
		(Dollars in thousands)		
Securities classified as trading:				
Residual interests	$	$	$ 2,057	$ 2,057
Mortgage-backed securities	328,210			328,210
Total securities classified as trading	328,210		2,057	330,267
Securities classified as available for sale	67,245		538,376	605,621
Loans available for sale		1,937,171		1,937,171
Loans held for investment		11,287		11,287
Residential mortgage servicing rights			649,133	649,133
Other investments-restricted	15,601			15,601
Derivative assets:				
Rate lock commitments			10,061	10,061
Forward agency and loan sales		27,764		27,764
Total derivative assets		27,764	10,061	37,825
Total assets at fair value	411,056	1,976,222	1,199,627	3,586,905
Derivative liabilities:				
Interest rate swaps	747			747
Agency forwards	29,883			29,883
U.S. Treasury futures	19,345			19,345
Total derivative liabilities	49,975			49,975
Warrant liabilities		5,111		5,111
Total liabilities at fair value	49,975	5,111		55,086
Net assets and liabilities at fair value	$361,081	$1,971,111	$1,199,627	$ 3,531,819

Changes in Level 3 fair value measurements

A determination to classify a financial instrument within Level 3 of the valuation hierarchy is based upon the significance of the unobservable factors to the overall fair value measurement. However, Level 3 financial instruments typically include, in addition to the unobservable or Level 3 components, observable components (that is, components that are actively quoted and can be validated to external sources). Accordingly, the gains and losses in the table below include changes in fair value due in part to observable factors that are included within the valuation methodology. Also, the Company manages the risk associated with the observable components of Level 3 financial instruments

using securities and derivative positions that are classified within Level 1 or Level 2 of the valuation hierarchy; these Level 1 and Level 2 risk management instruments are not included below, and therefore the gains and losses in the tables herein do not reflect the effect of the Company s risk management activities related to such Level 3 instruments.

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Fair value measurements using significant unobservable inputs

The tables below include a roll forward of the consolidated statement of financial condition amounts for the three and nine months ended September 30, 2010 and 2009 (including the change in fair value) for financial instruments classified by the Company within Level 3 of the valuation hierarchy:

For the Three Months Ended September 30, 2010	Fair Value, July 1, 2010	Total Realized/ Unrealized Gains/ (Losses)	Purchases, Issuances and Settlements, net	Transfers in and/or Out of Level 3	Fair Value September 30, 2010	Changes in Unrealized Gains and (Losses) Related to Financial Instruments Held at September 30, 2010
	(Dollars in thousands)					
Securities classified as trading:						
Residual interests [1]	$	$	$	$	$	$
Securities classified as available for sale [2][3]	517,406	4,365	(26,664)		495,107	4,364
Residential mortgage servicing rights	473,724	34,774	(61,476)		447,022	
Derivative financial instruments:						
Rate lock commitments	46,160		4,380		50,540	
Totals	$1,037,290	$39,139	$(83,760)	$	$992,669	$4,364

For the Three Months Ended September 30, 2009	Fair Value, July 1, 2009	Total Realized/ Unrealized Gains/ (Losses)	Purchases, Issuances and Settlements, net	Transfers In and/or Out of Level 3	Fair Value, September 30, 2009	Changes in Unrealized Gains and (Losses) Related to Financial Instruments Held at September 30, 2009
	(Dollars in thousands)					

Securities classified as trading:						
Residual interests [1]	$ 16,402	$ (13,133)	$	$	$ 3,269	$
Securities classified as available for sale [2] [3]	554,055	71,651	23,296		649,002	74,525
Residential mortgage servicing rights	658,209	(170,879)	76,699		564,029	
Derivative financial instruments:						
Rate lock commitments	29,200		11,405		40,605	
Totals	$1,257,866	$(112,361)	$111,400	$	$1,256,905	$74,525

(1) Residual interests are valued using internal inputs supplemented by independent third party inputs.

(2) Realized gains (losses), including unrealized losses deemed other-than-temporary and related to credit issues, are reported in non-interest income. Unrealized gains (losses) are reported in accumulated other comprehensive loss.

(3) U.S. government sponsored agency securities classified as available for sale are valued predominantly using quoted broker/dealer prices with adjustments to reflect for any assumptions a willing market participant would include in its valuation. Non-agency securities classified as available for sale are valued using internal valuation models and pricing information from third parties.

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For the Nine Months Ended September 30, 2010	Fair Value, January 1, 2010	Total Realized/ Unrealized Gains/ (Losses)	Purchases, Issuances and Settlements, net	Transfers in and/or Out of Level 3	Fair Value September 30, 2010	Changes in Unrealized Gains and (Losses) Related to Financial Instruments Held at September 30, 2010
	(Dollars in thousands)					
Securities classified as trading:						
Residual interests [1]	$ 2,057	$ (2,057)	$	$	$	$
Securities classified as available for sale [2][3]	538,376	26,602	(69,871)		495,107	30,279
Residential mortgage servicing rights	649,133	(233,541)	31,431		447,023	
Derivative financial instruments:						
Rate lock commitments	10,061		40,479		50,540	
Totals	$ 1,199,627	$ (208,996)	$ 2,039	$	$ 992,670	$ 30,279

For the Nine Months Ended September 30, 2009	Fair Value, January 1, 2009	Total Realized/ Unrealized Gains/ (Losses)	Purchases, Issuances and Settlements, net	Transfers In and/or Out of Level 3	Fair Value, September 30, 2009	Changes in Unrealized Gains and (Losses) Related to Financial Instruments Held at September 30, 2009
	(Dollars in thousands)					
Securities classified as trading:						
Residual interests [1]	$ 24,808	$ (21,539)	$	$	$ 3,269	$
Securities classified as available for sale [2] [3]	563,083	87,420	(1,501)		649,002	107,863
	511,294	(215,222)	267,957		564,029	

Residential mortgage servicing rights						
Derivative financial instruments:						
Rate lock commitments	78,613		(38,008)		40,605	
Totals	$1,177,798	$(149,341)	$228,448	$	$1,256,905	$107,863

(1) Residual interests are valued using internal inputs supplemented by independent third party inputs.

(2) Realized gains (losses), including unrealized losses deemed other-than-temporary and related to credit issues, are reported in non-interest income. Unrealized gains (losses) are reported in accumulated other comprehensive loss.

(3) U.S. government sponsored agency securities classified as available for sale are valued predominantly using quoted broker/dealer prices with adjustments to reflect for any assumptions a willing market participant would include in its valuation. Non-agency securities classified as available for sale are valued using internal valuation models and pricing information from third parties.

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The Company also has assets that under certain conditions are subject to measurement at fair value on a non-recurring basis. These assets are measured at the lower of cost or market and had a fair value below cost at the end of the period as summarized below:

Assets Measured at Fair Value on a Nonrecurring Basis

	Balance at September 30, 2010	Level 1	Level 2	Level 3
		(Dollars in thousands)		
Loans held for investment	$337,731	$	$337,731	$
Repossessed assets	198,585		198,585	
Consumer loan servicing rights				
Totals	$536,316	$	$536,316	$

	Balance at December 31, 2009	Level 1	Level 2	Level 3
		(Dollars in thousands)		
Loans held for investment	$557,808	$	$557,808	$
Repossessed assets	176,968		176,968	
Consumer loan servicing rights	3,241			3,241
Totals	$738,017	$	$734,776	$3,241

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Fair Value of Financial Instruments

The accounting guidance for financial instruments requires disclosures of the estimated fair value of certain financial instruments and the methods and significant assumptions used to estimate their fair values. Certain financial instruments and all nonfinancial instruments are excluded from the scope of this guidance. Accordingly, the fair value disclosures required by this guidance are only indicative of the value of individual financial instruments as of the dates indicated and should not be considered an indication of the fair value of the Company.

The following table presents the carrying amount and estimated fair value of certain financial instruments:

	September 30, 2010		December 31, 2009	
	Carrying Value	**Fair Value**	**Carrying Value**	**Fair Value**
	(Dollars in thousands)			
Financial Instruments:				
Assets:				
Cash and cash equivalents	$ 1,013,133	$ 1,013,133	$ 1,082,489	$ 1,082,489
Securities trading	161,000	161,000	330,267	330,267
Securities available for sale	503,568	503,568	605,621	605,621
Other investments restricted			15,601	15,601
Loans available for sale	1,943,096	1,959,348	1,970,104	1,975,819
Loans held for investment, net	6,838,226	6,824,347	7,190,308	7,120,802
Repossessed assets	198,585	198,585	176,968	176,968
FHLB stock	373,443	373,443	373,443	373,443
Mortgage servicing rights	447,023	447,023	652,374	652,656
Liabilities:				
Retail deposits:				
Demand deposits and savings accounts	(1,899,529)	(1,817,918)	(1,900,855)	(1,799,776)
Certificates of deposit	(3,494,141)	(3,588,690)	(3,546,616)	(3,643,218)
Government accounts	(770,404)	(774,507)	(557,495)	(549,990)
National certificates of deposit	(1,257,926)	(1,287,737)	(2,017,080)	(2,455,684)
Company controlled deposits	(1,139,943)	(1,138,705)	(756,423)	(756,423)
FHLB advances	(3,400,000)	(3,671,301)	(3,900,000)	(4,136,489)
Security repurchase agreements			(108,000)	(110,961)
Long term debt	(248,610)	(89,299)	(300,182)	(284,464)
Warrant liabilities	(1,447)	(1,447)	(5,111)	(5,111)
Derivative Financial Instruments:				
Forward delivery contracts	(19,117)	(19,117)	27,764	27,764
Commitments to extend credit	50,540	50,540	10,061	10,061
Interest rate swaps	(19)	(19)	(747)	(747)
U.S. Treasury and agency futures/forwards	(2,447)	(2,447)	(49,228)	(49,228)

The methods and assumptions that were used to estimate the fair value of financial assets and financial liabilities that are measured at fair value on a recurring or non-recurring basis are discussed above. The following methods and assumptions were used to estimate the fair value of other financial instruments for which it is practicable to estimate that value:

Cash and cash equivalents. Due to their short term nature, the carrying amount of cash and cash equivalents approximates fair value.

Loans held for investment. The fair value of loans is estimated by using internally developed discounted cash flow models using market interest rate inputs as well as management s best estimate of spreads for similar collateral.

FHLB stock. No secondary market exists for FHLB stock. The stock is bought and sold at par by the FHLB. Management believes that the recorded value is the fair value.

Deposit Accounts. The fair value of demand deposits and savings accounts approximates the carrying amount. The fair value of fixed-maturity certificates of deposit is estimated using the rates currently offered for certificates of deposits with similar remaining maturities.

FHLB Advances. Rates currently available to the Company for debt with similar terms and remaining maturities are used to estimate the fair value of the existing debt.

Security Repurchase Agreements. Rates currently available for repurchase agreements with similar terms and maturities are used to estimate fair values for these agreements.

Long Term Debt. The fair value of the long-term debt is estimated based on a discounted cash flow model that incorporates the Company s current borrowing rates for similar types of borrowing arrangements.

Note 7 Investment Securities

As of September 30, 2010 and December 31, 2009, investment securities were comprised of the following:

	Current Maturities	September 30, 2010	December 31, 2009
		(Dollars in thousands)	
Securities trading			
U.S. government treasury bonds	2012	$ 161,000	$
U.S. government sponsored agencies	2038-2039		328,210
Non-investment grade residual interests			2,057
Total securities trading		$ 161,000	$ 330,267
Securities available-for-sale			
Non-agency securities	2035-2037	$ 495,107	$ 538,376
U.S. government sponsored agencies	2010-2040	8,461	67,245
Total securities available-for-sale		$ 503,568	$ 605,621
Other investments restricted			
Mutual funds		$	$ 15,601

Trading

Securities classified as trading are comprised of AAA-rated U.S. government sponsored agency mortgage-backed securities, U.S. Treasury bonds, and non-investment grade residual interests from private-label securitizations. U.S. government sponsored agency mortgage-backed securities held in trading are distinguished from available-for-sale based upon the intent of the Company to use them as an economic offset against changes in the valuation of the MSR portfolio; however, these securities do not qualify as an accounting hedge.

For U.S. Treasury bonds and U.S. government sponsored agency mortgage-backed securities held, we recorded a gain of $76.7 million during the nine month period ended September 30, 2010, of which $4.1 million was unrealized gain on securities held at September 30, 2010. For the nine month period ended September 30, 2009, we recorded a net gain of $6.4 million, $16.8 million of which was unrealized loss on agency mortgage-backed securities at September 30, 2009.

The non-investment grade residual interests resulting from the Company s private label securitizations were zero at September 30, 2010 versus $2.1 million at December 31, 2009. The fair value of residual interests is determined by discounting estimated net future cash flows using discount rates that approximate current market rates and expected prepayment rates. Estimated net future cash flows include assumptions related to expected credit losses on these securities. The Company maintains a model that evaluates the default rate and severity of loss on the residual interests collateral, considering such factors as loss experience, delinquencies, loan-to-value ratios, borrower credit scores and property type. The fair value of non-investment grade residual securities classified as trading decreased as a result of the increase in the actual and expected losses in the second mortgages and HELOCs that underlie these assets.

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Available-for-Sale

Securities available-for-sale are carried at fair value, with unrealized gains and losses reported as a component of other comprehensive loss to the extent they are temporary in nature or other-than-temporary impairments (OTTI) as to non-credit related issues. If unrealized losses are, at any time, deemed to have arisen from OTTI, the credit related portion is reported as an expense for that period. At September 30, 2010 and December 31, 2009, the Company had $503.6 million and $605.6 million, respectively, in securities classified as available-for-sale which were comprised of U.S. government sponsored agency and non-agency collateralized mortgage obligations.

The following table summarizes the amortized cost and estimated fair value of U.S. government sponsored agency and non-agency collateralized mortgage obligations classified as available-for-sale:

	September 30, 2010	December 31, 2009
	(Dollars in thousands)	
Amortized cost	$ 549,039	$ 679,872
Gross unrealized holding gains	2,708	2,118
Gross unrealized holding losses	(48,179)	(76,369)
Estimated fair value	$ 503,568	$ 605,621

The following table summarizes by duration the unrealized loss positions, at September 30, 2010, on these securities:

	Unrealized Loss Position with Duration 12 Months and Over			Unrealized Loss Position with Duration Under 12 Months		
Type of Security	Principal	Number of Securities	Current Unrealized Loss	Principal	Number Of Securities	Current Unrealized Loss
	(Dollars in thousands)					
U.S. government sponsored agency securities	$		$	$ 7,866	22	$
Collateralized mortgage obligations	578,499	12	(48,179)			
Totals	$ 578,499	12	$ (48,179)	$ 7,866	22	$

The unrealized loss on securities-available-for-sale amounted to $48.2 million on $586.4 million of principal of agency and non-agency securities at September 30, 2010. These CMOs consist of interests in investment vehicles backed by mortgage loans.

An investment impairment analysis of these securities is triggered when the estimated market value is less than amortized cost for an extended period of time, generally six months. Before an analysis is performed, the Company also reviews the general market conditions for the specific type of underlying collateral for each security; in this case, the mortgage market in general has suffered from significant losses in value. With the assistance of third party experts as deemed necessary, the Company models the expected cash flows of the underlying mortgage assets using historical factors such as default rates, current delinquency rates and estimated factors such as prepayment speed, default speed and severity speed. Next, the cash flows are modeled through the appropriate waterfall for each tranche owned; in the case of CMOs the level of credit support provided by subordinated tranches is included in the waterfall analysis. The resulting cash flow of principal and interest is then utilized by management to determine the amount of credit losses by security.

The credit losses on the portfolio reflect the economic conditions present in the U.S. over the course of the last several years. This includes high mortgage defaults, declines in collateral values and changes in homeowner behavior, such as intentionally defaulting on a note due to a home value worth less than the outstanding debt on the home (so-called strategic defaults.)

In the nine month period ended September 30, 2010, additional OTTI due to credit losses on eight investments with existing other-than-temporary impairment credit losses totaled $3.7 million while additional OTTI due to credit loss was recognized on two securities that did not already have such losses; all OTTI due to credit losses was recognized in current operations.

At September 30, 2010, the Company had total other-than-temporary impairments of $35.2 million on 12 securities in the available-for-sale portfolio with $38.9 million in total credit losses recognized through operations. At December 31, 2009, the Company had total OTTI of $111.6 million on 12 securities in the available-for-sale portfolio with $35.3 million in total credit losses recognized through operations.

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The following table shows the activity for OTTI credit net loss for the nine months ended September 30, 2010:

	January 1, 2010 Balance	Additions on Securities with No Prior OTTI	Additions on Securities with Previous OTTI Recognized	Reduction For Sold Securities with OTTI	September 30, 2010 Balance
	(Dollars in thousands)				
Collateralized mortgage obligations	$ (35,272)		$ (3,677)		$ (38,949)

Gains (losses) on the sale of U.S. government sponsored agency mortgage-backed securities available for sale that are recently created with underlying mortgage products originated by the Company are reported within net gain on loan sale. Securities in this category have typically remained in the portfolio less than 90 days before sale. During the three months ended September 30, 2010, there was a $0.1 million loss on sales of $17.1 million of agency securities with underlying mortgage products recently originated by the Bank as compared with a $0.1 million gain on $190.5 million of sales during the quarter ended September 30, 2009. During the nine months ended September 30, 2010, sales of agency securities with underlying mortgage products originated by the Bank were $160.5 million resulting in $0.1 million of net gain on loan sale as compared with a $13.0 million gain on $653.0 million of sales during the nine month period ended September 30, 2009.

Gain (loss) on sales for all other available for sale securities types are reported in net gain on sale of available for sales securities. During the three months ended September 30, 2010 and 2009, the Company sold no U.S. government sponsored agency and non-agency securities available for sale. During the nine months ended September 30, 2010, the Company sold $251.0 million of agency and non-agency securities resulting in a net gain of $6.7 million versus no sales for the period ended September 30, 2009.

As of September 30, 2010, the aggregate amount of available-for-sale securities from each of the following non-agency issuers was greater than 10% of the Company s stockholders equity.

Name of Issuer	Amortized Cost	Fair Market Value
	(Dollars in thousands)	
Countrywide Home Loans	$ 182,064	$ 170,252
Flagstar Home Equity Loan Trust 2006-1	161,404	146,643
Total	$ 343,468	$ 316,895

Other Investments Restricted

The Company has other investments in its insurance subsidiary which are restricted as to their use. These assets are held in trust and can only be used to pay insurance claims in that subsidiary arising from mortgage reinsurance agreements with certain mortgage insurance companies. These securities had a fair value that approximates their recorded amount for each period presented. During 2009, the Company executed commutation agreements with two of the four mortgage insurance companies with which it had reinsurance agreements and terminated its agreement with one of the four mortgage insurance companies. During the third quarter 2010, the Company terminated its last reinsurance agreement with the last of the four mortgage insurance companies. Under each commutation agreement, the respective mortgage insurance company took back the ceded risk (thus again assuming the entire insured risk) and received rights to all of the related future premiums. In addition, the mortgage insurance company received all the cash held in trust attributable to the related reinsurance arrangement. The Company had securities related to its

remaining reinsurance agreements of zero and $15.6 million at September 30, 2010 and December 31, 2009, respectively.

Note 8 Loans Available for Sale

The following table summarizes loans available for sale:

	September 30, 2010	December 31, 2009
	(Dollars in thousands)	
Mortgage loans	$ 1,943,096	$ 1,970,104
Total	$ 1,943,096	$ 1,970,104

Effective January 1, 2009, the Company elected to record new originations of loans available for sale on the fair value method and as such no longer defers loan fees or expenses related to these loans. Because the fair value method was required to be adopted prospectively, only loans originated for sale on or after January 1, 2009 are affected. At September 30, 2010 and December 31, 2009, $1.8 billion and $1.9 billion of loans available for sale were recorded at fair value, respectively. The Company estimates the fair value of mortgage loans based on quoted market prices for securities backed by similar types of loans where quoted market prices are available. If such market prices are not available, the fair values of loans are estimated by discounting estimated cash flows using management s best estimate of market interest rates for similar collateral.

In addition, for certain loans sold to Ginnie Mae, the Company as the servicer, has the unilateral right to repurchase, without Ginnie Mae s prior authorization, any individual loan in a Ginnie Mae securitization pool if that loan meets certain criteria, including being delinquent greater than 90 days. Once the Company has the unilateral right to repurchase the delinquent loan, the Company has effectively regained control over the loan and must under U.S. GAAP, re-recognize the loan on its balance sheet, in loans available for sale, and establish a corresponding repurchase liability on its balance sheet regardless of the Company s intention to repurchase the loan. At September 30, 2010, the Company s re-recognized loans, included in loans available for sale, and corresponding liability, included in other liabilities, was $135.6 million.

Note 9 Loans Held for Investment

Loans held for investment are summarized as follows:

	September 30, 2010	December 31, 2009
	(Dollars in thousands)	
Mortgage loans	$ 4,479,814	$ 4,990,994
Second mortgage loans	185,062	221,626
Commercial real estate loans	1,341,009	1,600,271
Construction loans	9,956	16,642
Warehouse lending	913,494	448,567
Consumer loans	373,086	423,842
Commercial loans	9,805	12,366
Total	7,312,226	7,714,308
Less allowance for loan losses	(474,000)	(524,000)
Total	$ 6,838,226	$ 7,190,308

For the three and nine month periods ended, September 30, 2010, the Company transferred $7.5 million and $76.2 million, respectively in loans available for sale to loans held for investment. The loans transferred were carried at fair value, and continue to be reported at fair value while classified as held for investment.

Activity in the allowance for loan losses is summarized as follows:

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2010	2009	2010	2009
	(Dollars in thousands)			
Balance, beginning of period	$ 530,000	$ 474,000	$ 524,000	$ 376,000
Provision charged to operations	51,399	125,544	200,978	409,420
Charge-offs	(109,838)	(73,540)	(257,486)	(262,565)

Recoveries	2,439	1,996	6,508	5,145
Balance, end of period	$ 474,000	$ 528,000	$ 474,000	$ 528,000

There were loans totaling $14.6 million and $0.6 million greater than 90 days past due that were still accruing interest as of September 30, 2010 and 2009, respectively.

The Company may modify certain loans to retain customers or to maximize collection of the loan balance. The Company has maintained several programs designed to assist borrowers by extending payment dates or reducing the borrower s contractual payments. All loan modifications are made on a case by case basis. Loan modification programs for borrowers

implemented during 2009 and 2010 have resulted in a significant increase in restructured loans. These loans are classified as troubled debt restructurings (TDRs) and are included in non-accrual loans if the loan was non-accruing prior to the restructuring or if the payment amount increased significantly. At September 30, 2010, TDRs totaled $748.8 million of which $299.0 million were non-accruing.

Loans on which interest accruals have been discontinued totaled approximately $0.9 billion at September 30, 2010 and $1.1 billion at December 31, 2009. Loans are placed on non-accrual status when any portion of principal or interest is 90 days delinquent or earlier when concerns exist as to the ultimate collection of principal or interest. When a loan is placed on non-accrual status, the accrued and unpaid interest is reversed and interest income is recorded only as collected. Loans return to accrual status when principal and interest become current and are anticipated to be fully collectible. Interest income is recognized on impaired loans using a cost recovery method unless the receipt of principal and interest as they become contractually due is not in doubt. TDRs of impaired loans that perform under the restructured terms will remain on non-accrual status until the borrower has established a willingness and ability to make the restructured payment for at least six months, after which they will begin to accrue interest, provided the loan continues to perform according to its restructured terms. Interest that would have been accrued on non-accrual loans totaled approximately $26.8 million and $25.7 million during the nine months ended September 30, 2010 and 2009, respectively.

A loan is impaired when it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement. The following table details impaired loans by loan loss allowance allocation and interest earned.

	September 30, 2010	**December 31, 2009**
	(Dollars in thousands)	
Impaired loans with no allowance for loan losses allocated [1]	$ 112,183	$ 160,188
Impaired loans with allowance for loan losses allocated	859,621	891,022
Total impaired loans	$ 971,804	$ 1,051,210
Amount of the allowance allocated to impaired loans	$ 155,588	$ 172,741
Average investment in impaired loans	$ 1,024,964	$ 796,112
Cash-basis interest income recognized during impairment [2]	$ 23,892	$ 26,602

(1) Includes loans for which the principal balance has been charged down to net realizable value. Those impaired loans not requiring an allowance represents loans for which expected discounted cash flows or the fair value of the collateral less estimated selling costs exceeded the recorded investments in such loans. At September 30, 2010, approximately 43.72% of the total impaired loans were evaluated based on the fair value of related collateral.

(2) Includes interest income recognized during the nine months ended September 30, 2010 and year ended December 31, 2009, respectively.

The Company announced on November 2, 2010, that it had entered into an agreement to sell approximately $474.0 million of non-insured non-performing residential first mortgage loans and will reclassify an additional $86.0 million in residential non-performing loans as available for sale. See Note 3, Recent Developments, for further information.

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Note 10 Pledged Assets

The Company has pledged certain securities and loans to collateralize security repurchase agreements, lines of credit and/or borrowings with the Federal Reserve Bank of Chicago and the FHLB of Indianapolis and other potential future obligations. The following table details pledged asset by asset class, and the carrying value of pledged investments and the investments maturities.

	September 30, 2010		December 31, 2009	
	Carrying Value	Investment Maturities	Carrying Value	Investment Maturities
	(Dollars in thousands)			
Securities classified as trading:				
U.S. government treasury bonds	$ 158,945	2012	$	
U.S. government sponsored agencies			328,210	2038-2039
Securities classified as available for sale:				
U.S. government sponsored agencies	743	2010-2040	47,213	2010-2040
Non-agency securities	146,643	2035-2037	538,376	2035-2037
Loans held for investment:				
Mortgage loans	5,446,622	Various	5,526,865	Various
Second mortgage loans	154,371	Various	194,319	Various
Consumer loans	262,499	Various	286,602	Various
Commercial real estate loans	582,411	Various	751,472	Various
Other assets:				
Government guaranteed repurchased Ginnie Mae assets	1,515,928	Various		
Totals	$ 8,268,162		$ 7,673,057	

Note 11 Private-label Securitization Activity

The Company has, in the past, securitized fixed and adjustable rate second mortgage loans and home equity line of credit loans for sale in the non-agency secondary market. The Company acted as the principal underwriter of the beneficial interests that were sold to investors. The financial assets were derecognized when they were transferred to the securitization trust, which then issued and sold mortgage-backed securities to third party investors. The Company relinquished control over the loans at the time the financial assets were transferred to the securitization trust. The Company typically recognized a gain on the sale on the transferred assets.

The Company retained interests in the securitized mortgage loans and trusts, in the form of residual interests, transferor s interests, and servicing assets. The residual interests represent the present value of future cash flows expected to be received by the Company. Residual interests are accounted for at fair value and are included as securities classified as trading in the consolidated statement of financial condition. Any gains or losses realized on the sale of such securities and any subsequent changes in unrealized gains and losses are reported in the consolidated statement of operations. Transferor s interests represent all of the remaining interest in the assets within the securitization trust, which will equal the excess of the loan pool balance over the note principal balance and are comprised of the overcollateralization amount and any additional balance increase amount. Transferor s interests are included in loans held for investment in the consolidated statement of financial condition. Servicing assets represent the present value of future servicing cash flows expected to be received by the Company. These servicing assets are accounted for on an amortization method, and have been included in mortgage servicing rights in the consolidated statement of financial condition.

The Company recorded $26.1 million in residual interests as of December 31, 2005, as a result of its non-agency securitization of $600 million in home equity line of credit loans (the FSTAR 2005-1 HELOC

Securitization). In addition, until March 2008, draws on the home equity lines of credit in the trust established in the FSTAR 2005-1 HELOC Securitization were purchased from the Company by the trust, resulting in additional residual interests to the Company. These residual interests are recorded as securities classified as trading and therefore recorded at fair value. Any gains or losses realized on the sale of such securities and any subsequent changes in unrealized gains and losses have been reported in the consolidated statement of operations.

The Company recorded $11.2 million in residual interests as of December 31, 2006, as a result of its non-agency securitization of $302 million in home equity line of credit loans (the FSTAR 2006-2 HELOC Securitization). In addition, until November 2007, draws on the home equity lines of credit in the trust established in the FSTAR 2006-2 HELOC Securitization were purchased from the Company by the trust, resulting in additional residual interests to the Company. These residual interests were recorded as securities classified as trading and therefore recorded at fair value. Any gains or losses realized on the sale of such securities and any subsequent changes in unrealized gains and losses have been reported in the consolidated statement of operations.

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During 2009 and for the nine months ended September 30, 2010, the Company did not engage in any private-label securitization activity. At September 30, 2010, the Company had a zero balance of residuals as compared to $2.1 million at December 31, 2009. Transferor s interests at September 30, 2010 were $16.6 million as compared to $19.1 million at December 31, 2009.

Summary of Securitization Activity

Certain cash flows received from the securitization trusts were as follows:

	For the Three Months Ended			For the Nine Months Ended			
		30	20,868				
Subtotal	245,790	880	(1,048)	245,622	4,815	51,067	189,740
Total	$ 257,129	$ 880	$ (1,168)	$ 256,841	$15,157	$51,944	$189,740

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	September 24, 2016						
	Adjusted Cost	Unrealized Gains	Unrealized Losses	Fair Value	Cash and Cash Equivalents	Short-Term Marketable Securities	Long-Term Marketable Securities
Cash	$8,601	$ —	$ —	$8,601	$ 8,601	$ —	$ —
Level 1 (1):							
Money market funds	3,666	—	—	3,666	3,666	—	—
Mutual funds	1,407	—	(146)	1,261	—	1,261	—
Subtotal	5,073	—	(146)	4,927	3,666	1,261	—
Level 2 (2):							
U.S. Treasury securities	41,697	319	(4)	42,012	1,527	13,492	26,993
U.S. agency securities	7,543	16	—	7,559	2,762	2,441	2,356
Non-U.S. government securities	7,609	259	(27)	7,841	110	818	6,913
Certificates of deposit and time deposits	6,598	—	—	6,598	1,108	3,897	1,593
Commercial paper	7,433	—	—	7,433	2,468	4,965	—
Corporate securities	131,166	1,409	(206)	132,369	242	19,599	112,528
Municipal securities	956	5	—	961	—	167	794
Mortgage- and asset-backed securities	19,134	178	(28)	19,284	—	31	19,253
Subtotal	222,136	2,186	(265)	224,057	8,217	45,410	170,430
Total	$235,810	$ 2,186	$ (411)	$237,585	$ 20,484	$ 46,671	$ 170,430

(1) Level 1 fair value estimates are based on quoted prices in active markets for identical assets or liabilities.

(2) Level 2 fair value estimates are based on observable inputs other than quoted prices in active markets for identical assets and liabilities, quoted prices for identical or similar assets or liabilities in inactive markets, or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

The Company may sell certain of its marketable securities prior to their stated maturities for strategic reasons including, but not limited to, anticipation of credit deterioration and duration management. The maturities of the Company’s long-term marketable securities generally range from one to five years.

The Company considers the declines in market value of its marketable securities investment portfolio to be temporary in nature. The Company typically invests in highly-rated securities, and its investment policy generally limits the amount of credit exposure to any one issuer. The policy generally requires investments to be investment grade, with the primary objective of minimizing the potential risk of principal loss. Fair values were determined for each individual security in the investment portfolio. When evaluating an investment for other-than-temporary impairment, the Company reviews factors such as the length of time and extent to which fair value has been below its cost basis, the financial condition of the issuer and any changes thereto, changes in market interest rates and the Company’s intent to sell, or whether it is more likely than not it will be required to sell the investment before recovery of the investment’s cost basis. As of April 1, 2017, the Company does not consider any of its investments to be other-than-temporarily impaired.

Derivative Financial Instruments

The Company may use derivatives to partially offset its business exposure to foreign currency and interest rate risk on expected future cash flows, on net investments in certain foreign subsidiaries and on certain existing assets and liabilities. However, the Company may choose not to hedge certain exposures for a variety of reasons including, but not limited to, accounting considerations and the prohibitive economic cost of hedging particular exposures. There can

be no assurance the hedges will offset more than a portion of the financial impact resulting from movements in foreign currency exchange or interest rates.

To help protect gross margins from fluctuations in foreign currency exchange rates, certain of the Company's subsidiaries whose functional currency is the U.S. dollar may hedge a portion of forecasted foreign currency revenue, and subsidiaries whose functional currency is not the U.S. dollar and who sell in local currencies may hedge a portion of forecasted inventory purchases not denominated in the subsidiaries' functional currencies. The Company may enter into forward contracts, option contracts or other instruments to manage this risk and may designate these instruments as cash flow hedges. The Company typically hedges portions of its forecasted foreign currency exposure associated with revenue and inventory purchases, typically for up to 12 months.

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To help protect the net investment in a foreign operation from adverse changes in foreign currency exchange rates, the Company may enter into foreign currency forward and option contracts to offset the changes in the carrying amounts of these investments due to fluctuations in foreign currency exchange rates. In addition, the Company may use non-derivative financial instruments, such as its foreign currency-denominated debt, as economic hedges of its net investments in certain foreign subsidiaries. In both of these cases, the Company designates these instruments as net investment hedges.

The Company may also enter into non-designated foreign currency contracts to partially offset the foreign currency exchange gains and losses generated by the remeasurement of certain assets and liabilities denominated in non-functional currencies.

The Company may enter into interest rate swaps, options, or other instruments to manage interest rate risk. These instruments may offset a portion of changes in income or expense, or changes in fair value of the Company's term debt or investments. The Company designates these instruments as either cash flow or fair value hedges. The Company's hedged interest rate transactions as of April 1, 2017 are expected to be recognized within 10 years.

Cash Flow Hedges

The effective portions of cash flow hedges are recorded in accumulated other comprehensive income ("AOCI") until the hedged item is recognized in earnings. Deferred gains and losses associated with cash flow hedges of foreign currency revenue are recognized as a component of net sales in the same period as the related revenue is recognized, and deferred gains and losses related to cash flow hedges of inventory purchases are recognized as a component of cost of sales in the same period as the related costs are recognized. Deferred gains and losses associated with cash flow hedges of interest income or expense are recognized in other income/(expense), net in the same period as the related income or expense is recognized. The ineffective portions and amounts excluded from the effectiveness testing of cash flow hedges are recognized in other income/(expense), net.

Derivative instruments designated as cash flow hedges must be de-designated as hedges when it is probable the forecasted hedged transaction will not occur in the initially identified time period or within a subsequent two-month time period. Deferred gains and losses in AOCI associated with such derivative instruments are reclassified immediately into other income/(expense), net. Any subsequent changes in fair value of such derivative instruments are reflected in other income/(expense), net unless they are re-designated as hedges of other transactions.

Net Investment Hedges

The effective portions of net investment hedges are recorded in other comprehensive income ("OCI") as a part of the cumulative translation adjustment. The ineffective portions and amounts excluded from the effectiveness testing of net investment hedges are recognized in other income/(expense), net.

Fair Value Hedges

Gains and losses related to changes in fair value hedges are recognized in earnings along with a corresponding loss or gain related to the change in value of the underlying hedged item.

Non-Designated Derivatives

Derivatives that are not designated as hedging instruments are adjusted to fair value through earnings in the financial statement line item to which the derivative relates. As a result, during the three- and six-month periods ended April 1, 2017, respectively, the Company recognized a loss of $67 million and a gain of $206 million in net sales, a loss of $253 million and a gain of $79 million in cost of sales and a loss of $76 million and a gain of $432 million in other income/(expense), net.

The Company records all derivatives in the Condensed Consolidated Balance Sheets at fair value. The Company's accounting treatment for these derivative instruments is based on its hedge designation. The following tables show the Company's derivative instruments at gross fair value as of April 1, 2017 and September 24, 2016 (in millions):

	April 1, 2017		
	Fair Value of Derivatives Designated as Hedge Instruments	Fair Value of Derivatives Not Designated as Hedge Instruments	Total Fair Value
Derivative assets [(1)]:			

Foreign exchange contracts	$ 691	$ 272	$ 963
Interest rate contracts	$ 161	$ —	$ 161
Derivative liabilities [2]:			
Foreign exchange contracts	$ 832	$ 245	$ 1,077
Interest rate contracts	$ 354	$ —	$ 354

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	September 24, 2016		
	Fair Value of Derivatives Designated as Hedge Instruments	Fair Value of Derivatives Not Designated as Hedge Instruments	Total Fair Value
Derivative assets [1]:			
Foreign exchange contracts	$ 518	$ 153	$ 671
Interest rate contracts	$ 728	$ —	$ 728
Derivative liabilities [2]:			
Foreign exchange contracts	$ 935	$ 134	$ 1,069
Interest rate contracts	$ 7	$ —	$ 7

(1) The fair value of derivative assets is measured using Level 2 fair value inputs and is recorded as other current assets in the Condensed Consolidated Balance Sheets.

(2) The fair value of derivative liabilities is measured using Level 2 fair value inputs and is recorded as accrued expenses in the Condensed Consolidated Balance Sheets.

The following table shows the pre-tax gains and losses of the Company's derivative and non-derivative instruments designated as cash flow, net investment and fair value hedges in OCI and the Condensed Consolidated Statements of Operations for the three- and six-month periods ended April 1, 2017 and March 26, 2016 (in millions):

	Three Months Ended		Six Months Ended	
	April 1, 2017	March 26, 2016	April 1, 2017	March 26, 2016
Gains/(Losses) recognized in OCI – effective portion:				
Cash flow hedges:				
Foreign exchange contracts	$ (317)	$ (138)	$ 1,410	$ 188
Interest rate contracts	2	(50)	9	(42)
Total	$ (315)	$ (188)	$ 1,419	$ 146
Net investment hedges:				
Foreign exchange contracts	$ —	$ —	$ —	$ —
Foreign currency debt	(85)	(87)	37	(77)
Total	$ (85)	$ (87)	$ 37	$ (77)
Gains/(Losses) reclassified from AOCI into net income – effective portion:				
Cash flow hedges:				
Foreign exchange contracts	$ 1,344	$ 668	$ 833	$ 1,183
Interest rate contracts	(2)	(3)	(3)	(7)
Total	$ 1,342	$ 665	$ 830	$ 1,176
Gains/(Losses) on derivative instruments:				
Fair value hedges:				
Interest rate contracts	$ (50)	$ 250	$ (922)	$ 139
Gains/(Losses) related to hedged items:				
Fair value hedges:				
Interest rate contracts	$ 50	$ (250)	$ 922	$ (139)

The following table shows the notional amounts of the Company's outstanding derivative instruments and credit risk amounts associated with outstanding or unsettled derivative instruments as of April 1, 2017 and September 24, 2016 (in millions):

	April 1, 2017		September 24, 2016	
	Notional Amount	Credit Risk Amount	Notional Amount	Credit Risk Amount
Instruments designated as accounting hedges:				
Foreign exchange contracts	$37,550	$ 691	$44,678	$ 518
Interest rate contracts	$31,000	$ 161	$24,500	$ 728
Instruments not designated as accounting hedges:				
Foreign exchange contracts	$50,573	$ 272	$54,305	$ 153

The notional amounts for outstanding derivative instruments provide one measure of the transaction volume outstanding and do not represent the amount of the Company's exposure to credit or market loss. The credit risk amounts represent the Company's gross exposure to potential accounting loss on derivative instruments that are outstanding or unsettled if all counterparties failed to perform according to the terms of the contract, based on then-current currency or interest rates at each respective date. The Company's exposure to credit loss and market risk will vary over time as currency and interest rates change. Although the table above reflects the notional and credit risk amounts of the Company's derivative instruments, it does not reflect the gains or losses associated with the exposures and transactions that the instruments are intended to hedge. The amounts ultimately realized upon settlement of these financial instruments, together with the gains and losses on the underlying exposures, will depend on actual market conditions during the remaining life of the instruments.

The Company generally enters into master netting arrangements, which are designed to reduce credit risk by permitting net settlement of transactions with the same counterparty. To further limit credit risk, the Company generally enters into collateral security arrangements that provide for collateral to be received or posted when the net fair value of certain financial instruments fluctuates from contractually established thresholds. The Company presents its derivative assets and derivative liabilities at their gross fair values in its Condensed Consolidated Balance Sheets. As of April 1, 2017, the net cash collateral posted by the Company related to derivative instruments under its collateral security arrangements was $230 million, which was recorded as other current assets in the Condensed Consolidated Balance Sheet. As of September 24, 2016, the net cash collateral received by the Company related to derivative instruments under its collateral security arrangements was $163 million, which was recorded as accrued expenses in the Condensed Consolidated Balance Sheet.

Under master netting arrangements with the respective counterparties to the Company's derivative contracts, the Company is allowed to net settle transactions with a single net amount payable by one party to the other. As of both April 1, 2017 and September 24, 2016, the potential effects of these rights of set-off associated with the Company's derivative contracts, including the effects of collateral, would be a reduction to both derivative assets and derivative liabilities of $1.5 billion, resulting in a net derivative liability of $77 million as of April 1, 2017 and a net derivative asset of $160 million as of September 24, 2016.

Accounts Receivable

Trade Receivables

The Company has considerable trade receivables outstanding with its third-party cellular network carriers, wholesalers, retailers, value-added resellers, small and mid-sized businesses and education, enterprise and government customers. The Company generally does not require collateral from its customers; however, the Company will require collateral in certain instances to limit credit risk. In addition, when possible, the Company attempts to limit credit risk on trade receivables with credit insurance for certain customers or by requiring third-party financing, loans or leases to support credit exposure. These credit-financing arrangements are directly between the third-party financing company and the end customer. As such, the Company generally does not assume any recourse or credit risk sharing related to any of these arrangements.

As of April 1, 2017, the Company had two customers that individually represented 10% or more of total trade receivables, one of which accounted for 12% and the other 10%. As of September 24, 2016, the Company had one

customer that represented 10% or more of total trade receivables, which accounted for 10%. The Company's cellular network carriers accounted for 52% and 63% of trade receivables as of April 1, 2017 and September 24, 2016, respectively.
Vendor Non-Trade Receivables
The Company has non-trade receivables from certain of its manufacturing vendors resulting from the sale of components to these vendors who manufacture sub-assemblies or assemble final products for the Company. The Company purchases these components directly from suppliers. As of April 1, 2017, the Company had three vendors that individually accounted for 42%, 17% and 14% of total vendor non-trade receivables. As of September 24, 2016, the Company had two vendors that individually accounted for 47% and 21% of total vendor non-trade receivables.

Note 3 – Condensed Consolidated Financial Statement Details

The following tables show the Company's condensed consolidated financial statement details as of April 1, 2017 and September 24, 2016 (in millions):

Property, Plant and Equipment, Net

	April 1, 2017	September 24, 2016
Land and buildings	$11,746	$ 10,185
Machinery, equipment and internal-use software	46,688	44,543
Leasehold improvements	6,690	6,517
Gross property, plant and equipment	65,124	61,245
Accumulated depreciation and amortization	(37,961)	(34,235)
Total property, plant and equipment, net	$27,163	$ 27,010

Other Non-Current Liabilities

	April 1, 2017	September 24, 2016
Deferred tax liabilities	$28,226	$ 26,019
Other non-current liabilities	11,244	10,055
Total other non-current liabilities	$39,470	$ 36,074

Other Income/(Expense), Net

The following table shows the detail of other income/(expense), net for the three- and six-month periods ended April 1, 2017 and March 26, 2016 (in millions):

	Three Months Ended		Six Months Ended	
	April 1, 2017	March 26, 2016	April 1, 2017	March 26, 2016
Interest and dividend income	$ 1,282	$ 986	$2,506	$ 1,927
Interest expense	(530)	(321)	(1,055)	(597)
Other expense, net	(165)	(510)	(43)	(773)
Total other income/(expense), net	$ 587	$ 155	$1,408	$ 557

Note 4 – Acquired Intangible Assets

The Company's acquired intangible assets with definite useful lives primarily consist of patents and licenses. The following table summarizes the components of acquired intangible asset balances as of April 1, 2017 and September 24, 2016 (in millions):

	April 1, 2017			September 24, 2016		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Definite-lived and amortizable acquired intangible assets	$7,258	$ (4,741)	$ 2,517	$8,912	$ (5,806)	$ 3,106
Indefinite-lived and non-amortizable acquired intangible assets	100	—	100	100	—	100
Total acquired intangible assets	$7,358	$ (4,741)	$ 2,617	$9,012	$ (5,806)	$ 3,206

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Note 5 – Income Taxes

As of April 1, 2017, the Company recorded gross unrecognized tax benefits of $8.8 billion, of which $3.0 billion, if recognized, would affect the Company's effective tax rate. As of September 24, 2016, the total amount of gross unrecognized tax benefits was $7.7 billion, of which $2.8 billion, if recognized, would have affected the Company's effective tax rate. The Company's total gross unrecognized tax benefits are classified as other non-current liabilities in the Condensed Consolidated Balance Sheets. The Company had $1.3 billion and $1.0 billion of gross interest and penalties accrued as of April 1, 2017 and September 24, 2016, respectively, which are classified as other non-current liabilities in the Condensed Consolidated Balance Sheets.

The Company believes that an adequate provision has been made for any adjustments that may result from tax examinations. However, the outcome of tax audits cannot be predicted with certainty. If any issues addressed in the Company's tax audits are resolved in a manner not consistent with its expectations, the Company could be required to adjust its provision for income taxes in the period such resolution occurs. Although timing of the resolution and/or closure of audits is not certain, the Company believes it is reasonably possible that its gross unrecognized tax benefits could decrease (whether by payment, release or a combination of both) in the next 12 months by as much as $1.3 billion.

On August 30, 2016, the European Commission announced its decision that Ireland granted state aid to the Company by providing tax opinions in 1991 and 2007 concerning the tax allocation of profits of the Irish branches of two subsidiaries of the Company (the "State Aid Decision"). The State Aid Decision orders Ireland to calculate and recover additional taxes from the Company for the period June 2003 through December 2014. Irish legislative changes, effective as of January 2015, eliminated the application of the tax opinions from that date forward. The Company believes the State Aid Decision to be without merit and appealed to the General Court of the Court of Justice of the European Union. Ireland has also appealed the State Aid Decision. While the European Commission announced a recovery amount of up to €13 billion, plus interest, the actual amount of additional taxes subject to recovery is to be calculated by Ireland in accordance with the European Commission's guidance. Once the recovery amount is computed by Ireland, the Company anticipates funding it, including interest, out of foreign cash into escrow, where it will remain pending conclusion of all appeals. The Company believes that any incremental Irish corporate income taxes potentially due related to the State Aid Decision would be creditable against U.S. taxes.

Note 6 – Debt

Commercial Paper

The Company issues unsecured short-term promissory notes ("Commercial Paper") pursuant to a commercial paper program. The Company uses net proceeds from the commercial paper program for general corporate purposes, including dividends and share repurchases. As of April 1, 2017 and September 24, 2016, the Company had $10.0 billion and $8.1 billion of Commercial Paper outstanding, respectively, with maturities generally less than nine months. The weighted-average interest rate of the Company's Commercial Paper was 0.80% as of April 1, 2017 and 0.45% as of September 24, 2016.

The following table provides a summary of cash flows associated with the issuance and maturities of Commercial Paper for the six months ended April 1, 2017 and March 26, 2016 (in millions):

	Six Months Ended	
	April 1, 2017	March 26, 2016
Maturities less than 90 days:		
Proceeds from/(Repayments of) commercial paper, net	$(1,318)	$ 660
Maturities greater than 90 days:		
Proceeds from commercial paper	7,057	669
Repayments of commercial paper	(3,860)	(1,832)
Proceeds from/(Repayments of) commercial paper, net	3,197	(1,163)
Total change in commercial paper, net	$1,879	$ (503)

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Long-Term Debt

As of April 1, 2017, the Company had outstanding floating- and fixed-rate notes with varying maturities for an aggregate principal amount of $88.9 billion (collectively the "Notes"). The Notes are senior unsecured obligations, and interest is payable in arrears, quarterly for the U.S. dollar-denominated and Australian dollar-denominated floating-rate notes, semi-annually for the U.S. dollar-denominated, Australian dollar-denominated, British pound-denominated and Japanese yen-denominated fixed-rate notes and annually for the euro-denominated and Swiss franc-denominated fixed-rate notes. The following table provides a summary of the Company's term debt as of April 1, 2017 and September 24, 2016:

	Maturities	April 1, 2017 Amount (in millions)	April 1, 2017 Effective Interest Rate	September 24, 2016 Amount (in millions)	September 24, 2016 Effective Interest Rate
2013 debt issuance of $17.0 billion:					
Floating-rate notes	2018 2018	$2,000	1.10% 1.10%	$2,000	1.10% 1.10%
Fixed-rate 1.000% – 3.850% notes	2018–2043	12,500	1.08%–3.91%	12,500	1.08%–3.91%
2014 debt issuance of $12.0 billion:					
Floating-rate notes	2017–2019	2,000	1.10%–1.33%	2,000	0.86%–1.09%
Fixed-rate 1.050% – 4.450% notes	2017–2044	10,000	1.10%–4.48%	10,000	0.85%–4.48%
2015 debt issuances of $27.3 billion:					
Floating-rate notes	2017–2020	1,785	1.08%–1.87%	1,781	0.87%–1.87%
Fixed-rate 0.350% – 4.375% notes	2017–2045	24,668	0.28%–4.51%	25,144	0.28%–4.51%
2016 debt issuances of $24.9 billion:					
Floating-rate notes	2019–2021	1,350	1.17%–2.18%	1,350	0.91%–1.95%
Fixed-rate 1.100% – 4.650% notes	2018–2046	23,616	1.13%–4.78%	23,609	1.13%–4.58%
Second quarter 2017 debt issuance of $10.0 billion:					
Floating-rate notes	2019	500	1.12%	—	— %
Floating-rate notes	2020	500	1.24%	—	— %
Floating-rate notes	2022	1,000	1.54%	—	— %
Fixed-rate 1.550% notes	2019	500	1.59%	—	— %
Fixed-rate 1.900% notes	2020	1,000	1.24%	—	— %
Fixed-rate 2.500% notes	2022	1,500	1.53%	—	— %
Fixed-rate 3.000% notes	2024	1,750	1.83%	—	— %
Fixed-rate 3.350% notes	2027	2,250	1.98%	—	— %
Fixed-rate 4.250% notes	2047	1,000	4.26%	—	— %
Second quarter 2017 debt issuance of $1.0 billion:					
Fixed-rate 4.300% notes	2047	1,000	4.30%	—	— %
Total term debt		88,919		78,384	
Unamortized premium/(discount) and issuance costs, net		(184)		(174)	
Hedge accounting fair value adjustments		(205)		717	
Less: Current portion of long-term debt		(3,999)		(3,500)	
Total long-term debt		$84,531		$75,427	

During the second quarter of 2017, the Company issued $10.0 billion of U.S. dollar-denominated notes in the United States and $1.0 billion of U.S. dollar-denominated notes in Taiwan. To manage interest rate risk on the fixed-rate notes maturing in 2020, 2022, 2024 and 2027, the Company entered into interest rate swaps with an aggregate notional amount of $6.5 billion, which effectively converted the fixed interest rates on these notes to floating interest rates.

A portion of the Company's Japanese yen-denominated notes is designated as a hedge of the foreign currency exposure of the Company's net investment in a foreign operation. The foreign currency transaction gain or loss on the Japanese yen-denominated debt designated as a hedge is recorded in OCI as a part of the cumulative translation adjustment. As of April 1, 2017 and September 24, 2016, the carrying value of the debt designated as a net investment hedge was $1.7 billion and $1.9 billion, respectively. For further discussion regarding the Company’s use of derivative instruments see the Derivative Financial Instruments section of Note 2, “Financial Instruments.”

The effective interest rates for the Notes include the interest on the Notes, amortization of the discount and, if applicable, adjustments related to hedging. The Company recognized $507 million and $1.0 billion of interest expense on its term debt for the three- and six-month periods ended April 1, 2017, respectively. The Company recognized $311 million and $582 million of interest expense on its term debt for the three- and six-month periods ended March 26, 2016, respectively.

As of April 1, 2017 and September 24, 2016, the fair value of the Company's Notes, based on Level 2 inputs, was $89.7 billion and $81.7 billion, respectively.

Note 7 – Shareholders' Equity

Dividends

The Company declared and paid cash dividends per share during the periods presented as follows:

	Dividends Per Share	Amount (in millions)
2017:		
Second quarter	$ 0.57	$ 2,988
First quarter	0.57	3,042
Total cash dividends declared and paid	$ 1.14	$ 6,030
2016:		
Fourth quarter	$ 0.57	$ 3,071
Third quarter	0.57	3,117
Second quarter	0.52	2,879
First quarter	0.52	2,898
Total cash dividends declared and paid	$ 2.18	$ 11,965

Future dividends are subject to declaration by the Board of Directors.

Share Repurchase Program

As of April 1, 2017, the Company had an authorized share repurchase program of $175 billion of the Company's common stock, of which $151 billion had been utilized. The Company's share repurchase program does not obligate it to acquire any specific number of shares. Under the program, shares may be repurchased in privately negotiated and/or open market transactions, including under plans complying with Rule 10b5-1 under the Securities Exchange Act of 1934, as amended (the "Exchange Act").

The Company has entered, and in the future may enter, into accelerated share repurchase arrangements ("ASRs") with financial institutions. In exchange for up-front payments, the financial institutions deliver shares of the Company's common stock during the purchase periods of each ASR. The total number of shares ultimately delivered, and therefore the average repurchase price paid per share, is determined at the end of the applicable purchase period of each ASR based on the volume-weighted average price of the Company's common stock during that period. The shares received are retired in the periods they are delivered, and the up-front payments are accounted for as a reduction to shareholders' equity in the Company's Condensed Consolidated Balance Sheets in the periods the payments are made. The Company reflects the ASRs as a repurchase of common stock in the period delivered for purposes of calculating earnings per share and as forward contracts indexed to its own common stock. The ASRs met all of the applicable criteria for equity classification, and therefore were not accounted for as derivative instruments.

The following table shows the Company's ASR activity and related information during the six months ended April 1, 2017 and the year ended September 24, 2016:

	Purchase Period End Date	Number of Shares (in thousands)	Average Repurchase Price Per Share	ASR Amount (in millions)
February 2017 ASR	May 2017	17,527 (1)	(1)	$ 3,000
November 2016 ASR	February 2017	51,157 (2)	$ 117.29	$ 6,000
August 2016 ASR	November 2016	26,850	$ 111.73	$ 3,000
May 2016 ASR	August 2016	60,452	$ 99.25	$ 6,000
November 2015 ASR	April 2016	29,122	$ 103.02	$ 3,000

(1) "Number of Shares" represents those shares delivered at the beginning of the purchase period and does not represent the final number of shares to be delivered under the ASR. The total number of shares ultimately delivered, and therefore the average repurchase price paid per share, will be determined at the end of the purchase period based on the volume-weighted average price of the Company's common stock during that period. The February 2017 ASR purchase period will end in May 2017.

(2) Includes 44.8 million shares delivered and retired at the beginning of the purchase period, which began in the first quarter of 2017 and 6.3 million shares delivered and retired at the end of the purchase period, which concluded in the second quarter of 2017.

Additionally, the Company repurchased shares of its common stock in the open market, which were retired upon repurchase, during the periods presented as follows:

	Number of Shares (in thousands)	Average Repurchase Price Per Share	Amount (in millions)
2017:			
Second quarter	31,070	$ 128.74	$ 4,001
First quarter	44,333	$ 112.78	5,000
Total open market common stock repurchases	75,403		$ 9,001
2016:			
Fourth quarter	28,579	$ 104.97	$ 3,000
Third quarter	41,238	$ 97.00	4,000
Second quarter	71,766	$ 97.54	7,000
First quarter	25,984	$ 115.45	3,000
Total open market common stock repurchases	167,567		$ 17,000

Note 8 – Comprehensive Income

Comprehensive income consists of two components, net income and OCI. OCI refers to revenue, expenses, and gains and losses that under GAAP are recorded as an element of shareholders' equity but are excluded from net income. The Company's OCI consists of foreign currency translation adjustments from those subsidiaries not using the U.S. dollar as their functional currency, net deferred gains and losses on certain derivative instruments accounted for as cash flow hedges and unrealized gains and losses on marketable securities classified as available-for-sale.

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The following table shows the pre-tax amounts reclassified from AOCI into the Condensed Consolidated Statements of Operations, and the associated financial statement line item, for the three- and six-month periods ended April 1, 2017 and March 26, 2016 (in millions):

Comprehensive Income Components	Financial Statement Line Item	Three Months Ended April 1, 2017	Three Months Ended March 26, 2016	Six Months Ended April 1, 2017	Six Months Ended March 26, 2016
Unrealized (gains)/losses on derivative instruments:					
Foreign exchange contracts	Revenue	$ (408)	$ (325)	$ (509)	$ (654)
	Cost of sales	(570)	(219)	(557)	(525)
	Other income/(expense), net	(367)	(131)	237	(11)
Interest rate contracts	Other income/(expense), net	2	3	3	7
		(1,343)	(672)	(826)	(1,183)
Unrealized (gains)/losses on marketable securities	Other income/(expense), net	(20)	76	11	149
Total amounts reclassified from AOCI		$ (1,363)	$ (596)	$ (815)	$ (1,034)

The following table shows the changes in AOCI by component for the six months ended April 1, 2017 (in millions):

	Cumulative Foreign Currency Translation	Unrealized Gains/Losses on Derivative Instruments	Unrealized Gains/Losses on Marketable Securities	Total
Balance at September 24, 2016	$ (578)	$ 38	$ 1,174	$ 634
Other comprehensive income/(loss) before reclassifications	(193)	1,421	(2,077)	(849)
Amounts reclassified from AOCI	—	(826)	11	(815)
Tax effect	32	(153)	729	608
Other comprehensive income/(loss)	(161)	442	(1,337)	(1,056)
Balance at April 1, 2017	$ (739)	$ 480	$ (163)	$ (422)

Note 9 – Benefit Plans

Stock Plans

The Company had 317.4 million shares reserved for future issuance under its stock plans as of April 1, 2017. RSUs granted generally vest over four years, based on continued employment, and are settled upon vesting in shares of the Company's common stock on a one-for-one basis. Each share issued with respect to RSUs granted under the Company's stock plans reduces the number of shares available for grant under the plan by two shares. RSUs cancelled and shares withheld to satisfy tax withholding obligations increase the number of shares available for grant under the plans utilizing a factor of two times the number of RSUs cancelled or shares withheld.

Rule 10b5-1 Trading Plans

During the three months ended April 1, 2017, Section 16 officers Angela Ahrendts, Timothy D. Cook, Luca Maestri, Daniel Riccio and Philip Schiller had equity trading plans in place in accordance with Rule 10b5-1(c)(1) under the Exchange Act. An equity trading plan is a written document that pre-establishes the amounts, prices and dates (or formula for determining the amounts, prices and dates) of future purchases or sales of the Company's stock, including shares acquired pursuant to the Company's employee and director equity plans.

Restricted Stock Units

A summary of the Company's RSU activity and related information for the six months ended April 1, 2017 is as follows:

	Number of RSUs (in thousands)	Weighted-Average Grant Date Fair Value Per Share	Aggregate Fair Value (in millions)
Balance at September 24, 2016	99,089	$ 97.54	
RSUs granted	45,313	$ 118.36	
RSUs vested	(21,942)	$ 92.65	
RSUs cancelled	(3,227)	$ 105.68	
Balance at April 1, 2017	119,233	$ 106.13	$ 17,129

RSUs that vested during the three- and six-month periods ended April 1, 2017 had fair values of $460 million and $2.6 billion, respectively, as of the vesting date. RSUs that vested during the three- and six-month periods ended March 26, 2016 had fair values of $450 million and $2.5 billion, respectively, as of the vesting date.

Share-Based Compensation

The following table shows a summary of the share-based compensation expense included in the Condensed Consolidated Statements of Operations for the three- and six-month periods ended April 1, 2017 and March 26, 2016 (in millions):

	Three Months Ended		Six Months Ended	
	April 1, 2017	March 26, 2016	April 1, 2017	March 26, 2016
Cost of sales	$ 217	$ 191	$ 446	$ 395
Research and development	575	468	1,164	934
Selling, general and administrative	425	389	863	797
Total share-based compensation expense	$ 1,217	$ 1,048	$ 2,473	$ 2,126

The income tax benefit related to share-based compensation expense was $424 million and $889 million for the three- and six-month periods ended April 1, 2017, respectively, and was $347 million and $760 million for the three- and six-month periods ended March 26, 2016, respectively. As of April 1, 2017, the total unrecognized compensation cost related to outstanding RSUs, restricted stock and stock options was $10.0 billion, which the Company expects to recognize over a weighted-average period of 2.8 years.

Note 10 – Commitments and Contingencies

Accrued Warranty and Indemnification

The following table shows changes in the Company's accrued warranties and related costs for the three- and six-month periods ended April 1, 2017 and March 26, 2016 (in millions):

	Three Months Ended		Six Months Ended	
	April 1, 2017	March 26, 2016	April 1, 2017	March 26, 2016
Beginning accrued warranty and related costs	$ 4,698	$ 5,236	$ 3,702	$ 4,780
Cost of warranty claims	(1,031)	(1,128)	(2,368)	(2,397)
Accruals for product warranty	1,068	877	3,401	2,602
Ending accrued warranty and related costs	$ 4,735	$ 4,985	$ 4,735	$ 4,985

The Company generally does not indemnify end-users of its operating system and application software against legal claims that the software infringes third-party intellectual property rights. Other agreements entered into by the Company sometimes include indemnification provisions under which the Company could be subject to costs and/or damages in the event of an infringement claim against the Company or an indemnified third party. In the opinion of management, there was not at least a reasonable possibility the Company may have incurred a material loss with respect to indemnification of end-users of its operating system or application software for infringement of third-party intellectual property rights.

The Company offers an iPhone Upgrade Program, which is available to customers who purchase a qualifying iPhone in the U.S., the U.K. and mainland China. The iPhone Upgrade Program provides customers the right to trade in that iPhone for a specified amount when purchasing a new iPhone, provided certain conditions are met. The Company accounts for the trade-in right as a guarantee liability and recognizes arrangement revenue net of the fair value of such right with subsequent changes to the guarantee liability recognized within revenue.

The Company has entered into indemnification agreements with its directors and executive officers. Under these agreements, the Company has agreed to indemnify such individuals to the fullest extent permitted by law against liabilities that arise by reason of their status as directors or officers and to advance expenses incurred by such individuals in connection with related legal proceedings. It is not possible to determine the maximum potential amount of payments the Company could be required to make under these agreements due to the limited history of prior indemnification claims and the unique facts and circumstances involved in each claim. However, the Company maintains directors and officers liability insurance coverage to reduce its exposure to such obligations.

Concentrations in the Available Sources of Supply of Materials and Product

Although most components essential to the Company’s business are generally available from multiple sources, a number of components are currently obtained from single or limited sources. In addition, the Company competes for various components with other participants in the markets for mobile communication and media devices and personal computers. Therefore, many components used by the Company, including those that are available from multiple sources, are at times subject to industry-wide shortage and significant pricing fluctuations that could materially adversely affect the Company’s financial condition and operating results.

The Company uses some custom components that are not commonly used by its competitors, and new products introduced by the Company often utilize custom components available from only one source. When a component or product uses new technologies, initial capacity constraints may exist until the suppliers’ yields have matured or manufacturing capacity has increased. If the Company’s supply of components for a new or existing product were delayed or constrained, or if an outsourcing partner delayed shipments of completed products to the Company, the Company’s financial condition and operating results could be materially adversely affected. The Company’s business and financial performance could also be materially adversely affected depending on the time required to obtain sufficient quantities from the original source, or to identify and obtain sufficient quantities from an alternative source. Continued availability of these components at acceptable prices, or at all, may be affected if those suppliers decide to concentrate on the production of common components instead of components customized to meet the Company’s requirements.

The Company has entered into agreements for the supply of many components; however, there can be no guarantee that the Company will be able to extend or renew these agreements on similar terms, or at all. Therefore, the Company remains subject to significant risks of supply shortages and price increases that could materially adversely affect its financial condition and operating results.

Substantially all of the Company’s hardware products are manufactured by outsourcing partners that are located primarily in Asia. A significant concentration of this manufacturing is currently performed by a small number of outsourcing partners, often in single locations. Certain of these outsourcing partners are the sole-sourced suppliers of components and manufacturers for many of the Company’s products. Although the Company works closely with its outsourcing partners on manufacturing schedules, the Company’s operating results could be adversely affected if its outsourcing partners were unable to meet their production commitments. The Company’s manufacturing purchase obligations typically cover its requirements for periods up to 150 days.

Other Off-Balance Sheet Commitments

Operating Leases

The Company leases various equipment and facilities, including retail space, under noncancelable operating lease arrangements. The Company does not currently utilize any other off-balance sheet financing arrangements. As of April 1, 2017, the Company’s total future minimum lease payments under noncancelable operating leases were $8.2 billion. The Company's retail store and other facility leases are typically for terms not exceeding 10 years and generally contain multi-year renewal options.

Contingencies

The Company is subject to various legal proceedings and claims that have arisen in the ordinary course of business and that have not been fully adjudicated, as further discussed in Part II, Item 1 of this Form 10-Q under the heading "Legal Proceedings" and in Part II, Item 1A of this Form 10-Q under the heading "Risk Factors." In the opinion of management, there was not at least a reasonable possibility the Company may have incurred a material loss, or a material loss in excess of a recorded accrual, with respect to loss contingencies for asserted legal and other claims. However, the outcome of litigation is inherently uncertain. Therefore, although management considers the likelihood of such an outcome to be remote, if one or more of these legal matters were resolved against the Company in a reporting period for amounts in excess of management's expectations, the Company's consolidated financial statements for that reporting period could be materially adversely affected.

Apple Inc. v. Samsung Electronics Co., Ltd., et al.

On August 24, 2012, a jury returned a verdict awarding the Company $1.05 billion in its lawsuit against Samsung Electronics Co., Ltd. and affiliated parties in the United States District Court, Northern District of California, San Jose Division. On March 6, 2014, the District Court entered final judgment in favor of the Company in the amount of approximately $930 million. On May 18, 2015, the U.S. Court of Appeals for the Federal Circuit affirmed in part, and reversed in part, the decision of the District Court. As a result, the Court of Appeals ordered entry of final judgment on damages in the amount of approximately $548 million, with the District Court to determine supplemental damages and interest, as well as damages owed for products subject to the reversal in part. Samsung paid $548 million to the Company in December 2015, which was included in net sales in the Condensed Consolidated Statement of Operations. On December 6, 2016, the U.S. Supreme Court remanded the case to the U.S. Court of Appeals for the Federal Circuit for further proceedings related to the $548 million in damages. On February 7, 2017, the U.S. Court of Appeals for the Federal Circuit remanded the case to the District Court to determine what additional proceedings, if any, are needed. Because the case remains subject to further proceedings, the Company has not recognized any further amounts in its results of operations.

Note 11 – Segment Information and Geographic Data

The Company reports segment information based on the “management” approach. The management approach designates the internal reporting used by management for making decisions and assessing performance as the source of the Company’s reportable operating segments.

The Company manages its business primarily on a geographic basis. The Company’s reportable operating segments consist of the Americas, Europe, Greater China, Japan and Rest of Asia Pacific. The Americas segment includes both North and South America. The Europe segment includes European countries, as well as India, the Middle East and Africa. The Greater China segment includes China, Hong Kong and Taiwan. The Rest of Asia Pacific segment includes Australia and those Asian countries not included in the Company’s other reportable operating segments. Although the reportable operating segments provide similar hardware and software products and similar services, each one is managed separately to better align with the location of the Company’s customers and distribution partners and the unique market dynamics of each geographic region. The accounting policies of the various segments are the same as those described in Note 1, “Summary of Significant Accounting Policies” of the Notes to Consolidated Financial Statements in Part II, Item 8 of the 2016 Form 10-K.

The Company evaluates the performance of its reportable operating segments based on net sales and operating income. Net sales for geographic segments are generally based on the location of customers and sales through the Company’s retail stores located in those geographic locations. Operating income for each segment includes net sales to third parties, related cost of sales and operating expenses directly attributable to the segment. Advertising expenses are generally included in the geographic segment in which the expenditures are incurred. Operating income for each segment excludes other income and expense and certain expenses managed outside the reportable operating segments. Costs excluded from segment operating income include various corporate expenses such as research and development, corporate marketing expenses, certain share-based compensation expenses, income taxes, various nonrecurring charges and other separately managed general and administrative costs. The Company does not include intercompany transfers between segments for management reporting purposes.

The following table shows information by reportable operating segment for the three- and six-month periods ended April 1, 2017 and March 26, 2016 (in millions):

	Three Months Ended		Six Months Ended	
	April 1, 2017	March 26, 2016	April 1, 2017	March 26, 2016
Americas:				
Net sales	$21,157	$ 19,096	$53,125	$ 48,421
Operating income	$6,668	$ 6,116	$17,162	$ 16,134
Europe:				
Net sales	$12,733	$ 11,535	$31,254	$ 29,467
Operating income	$3,851	$ 3,602	$9,587	$ 9,381
Greater China:				
Net sales	$10,726	$ 12,486	$26,959	$ 30,859
Operating income	$4,224	$ 4,818	$10,400	$ 12,394
Japan:				
Net sales	$4,485	$ 4,281	$10,251	$ 9,075
Operating income	$2,037	$ 1,930	$4,710	$ 4,170
Rest of Asia Pacific:				
Net sales	$3,795	$ 3,159	$9,658	$ 8,607
Operating income	$1,309	$ 1,095	$3,538	$ 3,127

A reconciliation of the Company’s segment operating income to the Condensed Consolidated Statements of Operations for the three- and six-month periods ended April 1, 2017 and March 26, 2016 is as follows (in millions):

	Three Months Ended		Six Months Ended	
	April 1, 2017	March 26, 2016	April 1, 2017	March 26, 2016
Segment operating income	$18,089	$17,561	$45,397	$45,206
Research and development expense	(2,776)	(2,511)	(5,647)	(4,915)
Other corporate expenses, net	(1,216)	(1,063)	(2,294)	(2,133)
Total operating income	$14,097	$13,987	$37,456	$38,158

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations
This section and other parts of this Quarterly Report on Form 10 Q contain forward-looking statements, within the meaning of the Private Securities Litigation Reform Act of 1995, that involve risks and uncertainties. Forward-looking statements provide current expectations of future events based on certain assumptions and include any statement that does not directly relate to any historical or current fact. Forward-looking statements can also be identified by words such as "future," "anticipates," "believes," "estimates," "expects," "intends," "plans," "predicts," "will," "would," "could," "ca similar terms. Forward-looking statements are not guarantees of future performance and the Company's actual results may differ significantly from the results discussed in the forward-looking statements. Factors that might cause such differences include, but are not limited to, those discussed in Part II, Item 1A of this Form 10-Q under the heading "Risk Factors," which are incorporated herein by reference. The following discussion should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended September 24, 2016 (the "2016 Form 10-K") filed with the U.S. Securities and Exchange Commission (the "SEC") and the condensed consolidated financial statements and notes thereto included elsewhere in this Form 10-Q. All information presented herein is based on the Company's fiscal calendar. Unless otherwise stated, references to particular years, quarters, months or periods refer to the Company's fiscal years ended in September and the associated quarters, months and periods of those fiscal years. Each of the terms the "Company" and "Apple" as used herein refers collectively to Apple Inc. and its wholly-owned subsidiaries, unless otherwise stated. The Company assumes no obligation to revise or update any forward-looking statements for any reason, except as required by law.
Available Information
The Company's Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and amendments to reports filed pursuant to Sections 13(a) and 15(d) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), are filed with the SEC. The Company is subject to the informational requirements of the Exchange Act and files or furnishes reports, proxy statements, and other information with the SEC. Such reports and other information filed by the Company with the SEC are available free of charge on the Company's website at investor.apple.com/sec.cfm when such reports are available on the SEC's website. The public may read and copy any materials filed by the Company with the SEC at the SEC's Public Reference Room at 100 F Street, NE, Room 1580, Washington, DC 20549. The public may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. The SEC maintains an internet site that contains reports, proxy and information statements and other information regarding issuers that file electronically with the SEC at www.sec.gov. The contents of websites are not incorporated into this filing. Further, the Company's references to website URLs are intended to be inactive textual references only.
Overview and Highlights
The Company designs, manufactures and markets mobile communication and media devices and personal computers, and sells a variety of related software, services, accessories, networking solutions and third-party digital content and applications. The Company's products and services include iPhone®, iPad®, Mac®, Apple Watch®, Apple TV®, a portfolio of consumer and professional software applications, iOS, macOS®, watchOS® and tvOS™ operating systems, iCloud®, Apple Pay® and a variety of accessory, service and support offerings. The Company sells and delivers digital content and applications through the iTunes Store®, App Store®, Mac App Store, TV App Store, iBooks Store™ and Apple Music® (collectively "Digital Content and Services"). The Company sells its products worldwide through its retail stores, online stores and direct sales force, as well as through third-party cellular network carriers, wholesalers, retailers and value-added resellers. In addition, the Company sells a variety of third-party Apple-compatible products, including application software and various accessories through its retail and online stores. The Company sells to consumers, small and mid-sized businesses and education, enterprise and government customers.
Business Strategy
The Company is committed to bringing the best user experience to its customers through its innovative hardware, software and services. The Company's business strategy leverages its unique ability to design and develop its own operating systems, hardware, application software and services to provide its customers products and solutions with innovative design, superior ease-of-use and seamless integration. As part of its strategy, the Company continues to expand its platform for the discovery and delivery of digital content and applications through its Digital Content and Services, which allows customers to discover and download digital content, iOS, Mac, Apple Watch and Apple TV

applications, and books through either a Mac or Windows personal computer or through iPhone, iPad and iPod touch® devices ("iOS devices"), Apple TV and Apple Watch. The Company also supports a community for the development of third-party software and hardware products and digital content that complement the Company's offerings. The Company believes a high-quality buying experience with knowledgeable salespersons who can convey the value of the Company's products and services greatly enhances its ability to attract and retain customers. Therefore, the Company's strategy also includes building and expanding its own retail and online stores and its third-party distribution network to effectively reach more customers and provide them with a high-quality sales and post-sales support experience. The Company believes ongoing investment in research and development ("R&D"), marketing and advertising is critical to the development and sale of innovative products and technologies.

Business Seasonality and Product Introductions

The Company has historically experienced higher net sales in its first quarter compared to other quarters in its fiscal year due in part to seasonal holiday demand. Additionally, new product introductions can significantly impact net sales, product costs and operating expenses. Product introductions can also impact the Company's net sales to its indirect distribution channels as these channels are filled with new product inventory following a product introduction, and often, channel inventory of a particular product declines as the next related major product launch approaches. Net sales can also be affected when consumers and distributors anticipate a product introduction. However, neither historical seasonal patterns nor historical patterns of product introductions should be considered reliable indicators of the Company's future pattern of product introductions, future net sales or financial performance.

Fiscal Period

The Company's fiscal year is the 52 or 53-week period that ends on the last Saturday of September. The Company's fiscal year 2017 will include 53 weeks and will end on September 30, 2017. A 14th week was included in the first quarter of 2017, as is done every five or six years, to realign the Company's fiscal quarters with calendar quarters.

Second Quarter Fiscal 2017 Highlights

Net sales increased 5% or $2.3 billion during the second quarter of 2017 compared to the same quarter in 2016, primarily driven by strong growth in Services, Mac and Other Products, partially offset by the effect of weakness in foreign currencies relative to the U.S. dollar. Net sales reflected year-over-year growth in each of the geographic operating segments, with the exception of Greater China. During the second quarter of 2017, the Company introduced a new 9.7-inch iPad, which became available at the end of the quarter.

The Company utilized $7.0 billion to repurchase shares of its common stock and paid dividends and dividend equivalents of $3.0 billion during the second quarter of 2017. Additionally, the Company issued $11.0 billion of U.S. dollar-denominated long-term debt.

Sales Data

The following table shows net sales by operating segment and net sales and unit sales by product for the three- and six-month periods ended April 1, 2017 and March 26, 2016 (dollars in millions and units in thousands):

	Three Months Ended			Six Months Ended		
	April 1, 2017	March 26, 2016	Change	April 1, 2017	March 26, 2016	Change
Net Sales by Operating Segment:						
Americas	$21,157	$ 19,096	11 %	$53,125	$48,421	10 %
Europe	12,733	11,535	10 %	31,254	29,467	6 %
Greater China	10,726	12,486	(14)%	26,959	30,859	(13)%
Japan	4,485	4,281	5 %	10,251	9,075	13 %
Rest of Asia Pacific	3,795	3,159	20 %	9,658	8,607	12 %
Total net sales	$52,896	$ 50,557	5 %	$131,247	$126,429	4 %
Net Sales by Product:						
iPhone [(1)]	$33,249	$ 32,857	1 %	$87,627	$84,492	4 %
iPad [(1)]	3,889	4,413	(12)%	9,422	11,497	(18)%
Mac [(1)]	5,844	5,107	14 %	13,088	11,853	10 %
Services [(2)]	7,041	5,991	18 %	14,213	12,047	18 %
Other Products [(1)(3)]	2,873	2,189	31 %	6,897	6,540	5 %
Total net sales	$52,896	$ 50,557	5 %	$131,247	$126,429	4 %
Unit Sales by Product:						
iPhone	50,763	51,193	(1)%	129,053	125,972	2 %
iPad	8,922	10,251	(13)%	22,003	26,373	(17)%
Mac	4,199	4,034	4 %	9,573	9,346	2 %

(1)Includes deferrals and amortization of related software upgrade rights and non-software services.

(2)Includes revenue from Digital Content and Services, AppleCare®, Apple Pay, licensing and other services.

(3)Includes sales of Apple TV, Apple Watch, Beats® products, iPod and Apple-branded and third-party accessories.

Product Performance

iPhone

The following table presents iPhone net sales and unit sales information for the three- and six-month periods ended April 1, 2017 and March 26, 2016 (dollars in millions and units in thousands):

	Three Months Ended			Six Months Ended		
	April 1, 2017	March 26, 2016	Change	April 1, 2017	March 26, 2016	Change
Net sales	$33,249	$32,857	1 %	$87,627	$84,492	4 %
Percentage of total net sales	63 %	65 %		67 %	67 %	
Unit sales	50,763	51,193	(1)%	129,053	125,972	2 %

iPhone net sales increased during the second quarter of 2017 compared to the same period in 2016 due to higher iPhone average selling prices (“ASPs”), largely offset by the effect of weakness in foreign currencies relative to the U.S. dollar. The year-over-year increase in iPhone net sales during the first six months of 2017 was due primarily to higher iPhone unit sales and to a lesser extent higher iPhone ASPs, partially offset by the effect of weakness in foreign currencies relative to the U.S. dollar.

iPad

The following table presents iPad net sales and unit sales information for the three- and six-month periods ended April 1, 2017 and March 26, 2016 (dollars in millions and units in thousands):

	Three Months Ended			Six Months Ended		
	April 1, 2017	March 26, 2016	Change	April 1, 2017	March 26, 2016	Change
Net sales	$3,889	$4,413	(12)%	$9,422	$11,497	(18)%
Percentage of total net sales	7 %	9 %		7 %	9 %	
Unit sales	8,922	10,251	(13)%	22,003	26,373	(17)%

iPad net sales decreased in the second quarter and first six months of 2017 compared to the same periods in 2016 due primarily to lower iPad unit sales in each of the geographic operating segments and to a lesser extent the effect of weakness in foreign currencies relative to the U.S. dollar.

Mac

The following table presents Mac net sales and unit sales information for the three- and six-month periods ended April 1, 2017 and March 26, 2016 (dollars in millions and units in thousands):

	Three Months Ended			Six Months Ended		
	April 1, 2017	March 26, 2016	Change	April 1, 2017	March 26, 2016	Change
Net sales	$5,844	$5,107	14 %	$13,088	$11,853	10 %
Percentage of total net sales	11 %	10 %		10 %	9 %	
Unit sales	4,199	4,034	4 %	9,573	9,346	2 %

Mac net sales increased during the second quarter and first six months of 2017 compared to the same periods in 2016 due primarily to a different mix of Macs, including the new MacBook Pro introduced in the first quarter of 2017, and to a lesser extent higher Mac unit sales. The year-over-year increase in Mac net sales was partially offset by the effect of weakness in foreign currencies relative to the U.S. dollar.

Services

The following table presents Services net sales information for the three- and six-month periods ended April 1, 2017 and March 26, 2016 (dollars in millions):

	Three Months Ended			Six Months Ended		
	April 1, 2017	March 26, 2016	Change	April 1, 2017	March 26, 2016	Change
Net sales	$7,041	$5,991	18 %	$14,213	$12,047	18 %
Percentage of total net sales	13 %	12 %		11 %	10 %	

The year-over-year increase in Services net sales in the second quarter and first six months of 2017 compared to the same periods in 2016 was due primarily to growth from the App Store and licensing sales. The year-over-year increase in Services net sales during the first six months of 2017 was partially offset by the non-recurrence of the $548 million received from Samsung Electronics Co., Ltd. in the first quarter of 2016 related to patent infringement matters.

Segment Operating Performance

The Company manages its business primarily on a geographic basis. The Company's reportable operating segments consist of the Americas, Europe, Greater China, Japan and Rest of Asia Pacific. The Americas segment includes both North and South America. The Europe segment includes European countries, as well as India, the Middle East and Africa. The Greater China segment includes China, Hong Kong and Taiwan. The Rest of Asia Pacific segment includes Australia and those Asian countries not included in the Company's other reportable operating segments. Although the reportable operating segments provide similar hardware and software products and similar services, each one is managed separately to better align with the location of the Company's customers and distribution partners and the unique market dynamics of each geographic region. Further information regarding the Company's reportable operating segments can be found in Part I, Item 1 of this Form 10-Q in the Notes to Condensed Consolidated Financial Statements, in Note 11, "Segment Information and Geographic Data."

Americas

The following table presents Americas net sales information for the three- and six-month periods ended April 1, 2017 and March 26, 2016 (dollars in millions):

	Three Months Ended			Six Months Ended		
	April 1, 2017	March 26, 2016	Change	April 1, 2017	March 26, 2016	Change
Net sales	$21,157	$19,096	11 %	$53,125	$48,421	10 %
Percentage of total net sales	40 %	38 %		40 %	38 %	

Americas net sales increased during the second quarter of 2017 compared to the same period in 2016 due primarily to higher net sales of iPhone and Other Products. The year-over-year increase in Americas net sales during the first six months of 2017 was due primarily to higher net sales of iPhone and Mac, partially offset by lower net sales of iPad.

Europe

The following table presents Europe net sales information for the three- and six-month periods ended April 1, 2017 and March 26, 2016 (dollars in millions):

	Three Months Ended			Six Months Ended		
	April 1, 2017	March 26, 2016	Change	April 1, 2017	March 26, 2016	Change
Net sales	$12,733	$11,535	10 %	$31,254	$29,467	6 %
Percentage of total net sales	24 %	23 %		24 %	23 %	

Europe net sales increased during the second quarter of 2017 compared to the same period in 2016 due primarily to higher net sales of iPhone and Mac, partially offset by the effect of weakness in foreign currencies relative to the U.S. dollar. The year-over-year increase in Europe net sales during the first six months of 2017 was due primarily to higher net sales of iPhone and Services, partially offset by the effect of weakness in foreign currencies relative to the U.S. dollar and to a lesser extent lower net sales of iPad.

Greater China

The following table presents Greater China net sales information for the three- and six-month periods ended April 1, 2017 and March 26, 2016 (dollars in millions):

	Three Months Ended			Six Months Ended		
	April 1, 2017	March 26, 2016	Change	April 1, 2017	March 26, 2016	Change
Net sales	$10,726	$12,486	(14)%	$26,959	$30,859	(13)%
Percentage of total net sales	20 %	25 %		21 %	24 %	

Greater China net sales decreased during the second quarter and first six months of 2017 compared to the same periods in 2016 due primarily to lower net sales of iPhone and the effect of weakness in foreign currencies relative to the U.S. dollar, partially offset by growth in net sales of Services.

Japan

The following table presents Japan net sales information for the three- and six-month periods ended April 1, 2017 and March 26, 2016 (dollars in millions):

	Three Months Ended			Six Months Ended		
	April 1, 2017	March 26, 2016	Change	April 1, 2017	March 26, 2016	Change
Net sales	$4,485	$4,281	5 %	$10,251	$9,075	13 %
Percentage of total net sales	8 %	8 %		8 %	7 %	

Japan net sales increased during the second quarter of 2017 compared to the same period in 2016 due primarily to higher net sales of Services and the effect of strength in the Japanese yen relative to the U.S. dollar. The year-over-year increase in Japan net sales during the first six months of 2017 was due primarily to the effect of strength in the Japanese yen relative to the U.S. dollar and growth in net sales of iPhone.

Rest of Asia Pacific

The following table presents Rest of Asia Pacific net sales information for the three- and six-month periods ended April 1, 2017 and March 26, 2016 (dollars in millions):

	Three Months Ended			Six Months Ended		
	April 1, 2017	March 26, 2016	Change	April 1, 2017	March 26, 2016	Change
Net sales	$3,795	$3,159	20 %	$9,658	$8,607	12 %
Percentage of total net sales	7 %	6 %		7 %	7 %	

Rest of Asia Pacific net sales increased during the second quarter of 2017 compared to the same period in 2016 due primarily to higher net sales of iPhone and Mac. The year-over-year increase in Rest of Asia Pacific net sales during the first six months of 2017 was due primarily to higher net sales of iPhone and the effect of strength in foreign currencies relative to the U.S. dollar.

Gross Margin

Gross margin for the three- and six-month periods ended April 1, 2017 and March 26, 2016 was as follows (dollars in millions):

	Three Months Ended		Six Months Ended	
	April 1, 2017	March 26, 2016	April 1, 2017	March 26, 2016
Net sales	$52,896	$50,557	$131,247	$126,429
Cost of sales	32,305	30,636	80,480	76,085
Gross margin	$20,591	$19,921	$50,767	$50,344
Gross margin percentage	38.9 %	39.4 %	38.7 %	39.8 %

Gross margin decreased during the second quarter and first six months of 2017 compared to the same periods in 2016 due primarily to higher product cost structures and the effect of weakness in foreign currencies relative to the U.S. dollar, partially offset by a favorable mix of products and services.

The Company anticipates gross margin during the third quarter of 2017 to be between 37.5% and 38.5%. The foregoing statement regarding the Company's expected gross margin percentage in the third quarter of 2017 is forward-looking and could differ from actual results. The Company's future gross margins can be impacted by multiple factors including, but not limited to, those set forth in Part II, Item 1A of this Form 10-Q under the heading "Risk Factors" and those described in this paragraph. In general, the Company believes gross margins will remain under downward pressure due to a variety of factors, including continued industry-wide global product pricing pressures, increased competition, compressed product life cycles, product transitions, potential increases in the cost of components, and potential strengthening of the U.S. dollar, as well as potential increases in the costs of outside manufacturing services and a potential shift in the Company's sales mix towards products with lower gross margins. In response to competitive pressures, the Company expects it will continue to take product pricing actions, which would adversely affect gross margins. Gross margins could also be affected by the Company's ability to manage product quality and warranty costs effectively and to stimulate demand for certain of its products. Due to the Company's significant international operations, its financial condition and operating results, including gross margins, could be significantly affected by fluctuations in exchange rates.

Operating Expenses

Operating expenses for the three- and six-month periods ended April 1, 2017 and March 26, 2016 were as follows (dollars in millions):

	Three Months Ended		Six Months Ended	
	April 1, 2017	March 26, 2016	April 1, 2017	March 26, 2016
Research and development	$2,776	$2,511	$5,647	$4,915
Percentage of total net sales	5 %	5 %	4 %	4 %
Selling, general and administrative	$3,718	$3,423	$7,664	$7,271
Percentage of total net sales	7 %	7 %	6 %	6 %
Total operating expenses	$6,494	$5,934	$13,311	$12,186
Percentage of total net sales	12 %	12 %	10 %	10 %

Research and Development

The growth in R&D expense during the second quarter and first six months of 2017 compared to the same periods in 2016 was driven primarily by an increase in headcount and related expenses to support expanded R&D activities. The Company continues to believe that focused investments in R&D are critical to its future growth and competitive position in the marketplace, and to the development of new and updated products that are central to the Company's core business strategy.

Selling, General and Administrative

The growth in selling, general and administrative expense during the second quarter of 2017 compared to the same quarter in 2016 was driven primarily by an increase in headcount and related expenses and higher spending on marketing and advertising. The year-over-year growth in selling, general and administrative expense during the first six months of 2017 was driven primarily by an increase in headcount and related expenses and higher variable selling costs.

Other Income/(Expense), Net

Other income/(expense), net for the three- and six-month periods ended April 1, 2017 and March 26, 2016 was as follows (dollars in millions):

	Three Months Ended			Six Months Ended		
	April 1, 2017	March 26, 2016	Change	April 1, 2017	March 26, 2016	Change
Interest and dividend income	$1,282	$ 986		$2,506	$ 1,927	
Interest expense	(530)	(321)		(1,055)	(597)	
Other expense, net	(165)	(510)		(43)	(773)	
Total other income/(expense), net	$587	$ 155	279 %	$1,408	$ 557	153 %

The increase in other income/(expense), net during the second quarter and first six months of 2017 compared to the same periods in 2016 was due primarily to higher interest income and the favorable impact of foreign

exchange-related items, partially offset by higher interest expense on debt. The weighted-average interest rate earned by the Company on its cash, cash equivalents and marketable securities was 1.99% and 1.74% in the second quarter of 2017 and 2016, respectively, and 1.93% and 1.70% in the first six months of 2017 and 2016, respectively.
Provision for Income Taxes
Provision for income taxes and effective tax rates for the three- and six-month periods ended April 1, 2017 and March 26, 2016 were as follows (dollars in millions):

	Three Months Ended		Six Months Ended	
	April 1, 2017	March 26, 2016	April 1, 2017	March 26, 2016
Provision for income taxes	$3,655	$3,626	$9,944	$9,838
Effective tax rate	24.9 %	25.6 %	25.6 %	25.4 %

The Company’s effective tax rates during the second quarter of 2017 and 2016 differ from the statutory federal income tax rate of 35% due primarily to certain undistributed foreign earnings, a substantial portion of which was generated by subsidiaries organized in Ireland, for which no U.S. taxes are provided when such earnings are intended to be indefinitely reinvested outside the U.S. The lower effective tax rate during the second quarter of 2017 compared to the same quarter in 2016 was due primarily to a different geographic mix of earnings. The slightly higher effective tax rate in the first six months of 2017 compared to the same period in 2016 was due primarily to the retroactive reinstatement of the U.S. federal R&D tax credit during the first quarter of 2016.
The Company is subject to audits by federal, state, local and foreign tax authorities. Management believes that adequate provisions have been made for any adjustments that may result from tax examinations. However, the outcome of tax audits cannot be predicted with certainty. If any issues addressed in the Company’s tax audits are resolved in a manner not consistent with management’s expectations, the Company could be required to adjust its provision for income taxes in the period such resolution occurs.
On August 30, 2016, the European Commission announced its decision that Ireland granted state aid to the Company by providing tax opinions in 1991 and 2007 concerning the tax allocation of profits of the Irish branches of two subsidiaries of the Company (the “State Aid Decision”). The State Aid Decision orders Ireland to calculate and recover additional taxes from the Company for the period June 2003 through December 2014. Irish legislative changes, effective as of January 2015, eliminated the application of the tax opinions from that date forward. The Company believes the State Aid Decision to be without merit and appealed to the General Court of the Court of Justice of the European Union. Ireland has also appealed the State Aid Decision. While the European Commission announced a recovery amount of up to €13 billion, plus interest, the actual amount of additional taxes subject to recovery is to be calculated by Ireland in accordance with the European Commission's guidance. Once the recovery amount is computed by Ireland, the Company anticipates funding it, including interest, out of foreign cash into escrow, where it will remain pending conclusion of all appeals. The Company believes that any incremental Irish corporate income taxes potentially due related to the State Aid Decision would be creditable against U.S. taxes.
Recent Accounting Pronouncements
Restricted Cash
In November 2016, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2016-18, Statement of Cash Flows (Topic 230): Restricted Cash (“ASU 2016-18”), which enhances and clarifies the guidance on the classification and presentation of restricted cash in the statement of cash flows. The Company will adopt ASU 2016-18 in its first quarter of 2019 utilizing the retrospective adoption method. Currently, the Company's restricted cash balance is not significant.
Income Taxes
In October 2016, the FASB issued ASU No. 2016-16, Income Taxes (Topic 740): Intra-Entity Transfers of Assets Other Than Inventory (“ASU 2016-16”), which requires the recognition of the income tax consequences of an intra-entity transfer of an asset, other than inventory, when the transfer occurs. The Company will adopt ASU 2016-16 in its first quarter of 2019 utilizing the modified retrospective adoption method. Currently, the Company anticipates recording up to $9 billion of net deferred tax assets on its Consolidated Balance Sheets. However, the ultimate impact of adopting ASU 2016-16 will depend on the balance of intellectual property transferred between its subsidiaries as of the adoption date. The Company will recognize incremental deferred income tax expense thereafter as these deferred tax assets are utilized.

Stock Compensation

In March 2016, the FASB issued ASU No. 2016-09, Compensation – Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting (“ASU 2016-09”), which modifies certain aspects of the accounting for share-based payment transactions, including income taxes, classification of awards, and classification in the statement of cash flows. The Company will adopt ASU 2016-09 in its first quarter of 2018. Currently, excess tax benefits or deficiencies from the Company's equity awards are recorded as additional paid-in capital in its Consolidated Balance Sheets. Upon adoption, the Company will record any excess tax benefits or deficiencies from its equity awards in its Consolidated Statements of Operations in the reporting periods in which vesting occurs. As a result, subsequent to adoption the Company's income tax expense and associated effective tax rate will be impacted by fluctuations in stock price between the grant dates and vesting dates of equity awards.

Leases

In February 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842) (“ASU 2016-02”), which modifies lease accounting for lessees to increase transparency and comparability by recording lease assets and liabilities for operating leases and disclosing key information about leasing arrangements. ASU 2016-02 will be effective for the Company beginning in its first quarter of 2020, and early adoption is permitted. The Company will use a modified retrospective adoption approach. While the Company is currently evaluating the timing and impact of adopting ASU 2016-02, currently the Company anticipates recording lease assets and liabilities in excess of $8.2 billion on its Consolidated Balance Sheets, with no material impact to its Consolidated Statements of Operations. However, the ultimate impact of adopting ASU 2016-02 will depend on the Company's lease portfolio as of the adoption date.

Financial Instruments

In January 2016, the FASB issued ASU No. 2016-01, Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities (“ASU 2016-01”), which updates certain aspects of recognition, measurement, presentation and disclosure of financial instruments. The Company will adopt ASU 2016-01 in its first quarter of 2019 utilizing the modified retrospective adoption method. Based on the composition of the Company's investment portfolio, the adoption of ASU 2016-01 is not expected to have a material impact on its consolidated financial statements.

In June 2016, the FASB issued ASU No. 2016-13, Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments (“ASU 2016-13”), which modifies the measurement of expected credit losses of certain financial instruments. The Company will adopt ASU 2016-13 in its first quarter of 2021 utilizing the modified retrospective adoption method. Based on the composition of the Company's investment portfolio, current market conditions, and historical credit loss activity, the adoption of ASU 2016-13 is not expected to have a material impact on its consolidated financial statements.

Revenue Recognition

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606) (“ASU 2014-09”), which amends the existing accounting standards for revenue recognition. ASU 2014-09 is based on principles that govern the recognition of revenue at an amount an entity expects to be entitled when products are transferred to customers.

Subsequently, the FASB has issued the following standards related to ASU 2014-09: ASU No. 2016-08, Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (“ASU 2016-08”); ASU No. 2016-10, Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing (“ASU 2016-10”); ASU No. 2016-12, Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients (“ASU 2016-12”); and ASU No. 2016-20, Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers (“ASU 2016-20”). The Company must adopt ASU 2016-08, ASU 2016-10, ASU 2016-12 and ASU 2016-20 with ASU 2014-09 (collectively, the “new revenue standards”).

The new revenue standards may be applied retrospectively to each prior period presented or retrospectively with the cumulative effect recognized as of the date of adoption. The Company plans to adopt the new revenue standards in its first quarter of 2019 utilizing the full retrospective adoption method. The new revenue standards are not expected to have a material impact on the amount and timing of revenue recognized in the Company's consolidated financial statements.

Liquidity and Capital Resources

The following tables present selected financial information and statistics as of April 1, 2017 and September 24, 2016 and for the first six months of 2017 and 2016 (in millions):

	April 1, 2017	September 24, 2016
Cash, cash equivalents and marketable securities	$256,841	$ 237,585
Property, plant and equipment, net	$27,163	$ 27,010
Commercial paper	$9,992	$ 8,105
Total term debt	$88,530	$ 78,927
Working capital	$28,648	$ 27,863

	Six Months Ended	
	April 1, 2017	March 26, 2016
Cash generated by operating activities	$39,579	$39,064
Cash used in investing activities	$(33,324)	$(34,110)
Cash used in financing activities	$(11,582)	$(4,560)

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The Company believes its existing balances of cash, cash equivalents and marketable securities will be sufficient to satisfy its working capital needs, capital asset purchases, outstanding commitments and other liquidity requirements associated with its existing operations over the next 12 months. The Company currently anticipates the cash used for future dividends, the share repurchase program and debt repayments will come from its current domestic cash, cash generated from ongoing U.S. operating activities and from borrowings.

As of April 1, 2017 and September 24, 2016, the Company's cash, cash equivalents and marketable securities held by foreign subsidiaries were $239.6 billion and $216.0 billion, respectively, and are generally based in U.S. dollar-denominated holdings. Amounts held by foreign subsidiaries are generally subject to U.S. income taxation on repatriation to the U.S. In connection with the State Aid Decision, the European Commission announced a recovery amount of up to €13 billion, plus interest. The actual amount of additional taxes subject to recovery is to be calculated by Ireland in accordance with the European Commission's guidance. Once the recovery amount is computed by Ireland, the Company anticipates funding it, including interest, out of foreign cash into escrow, where it will remain pending conclusion of all appeals.

The Company's marketable securities investment portfolio is primarily invested in highly-rated securities, and its investment policy generally limits the amount of credit exposure to any one issuer. The policy generally requires investments to be investment grade, with the primary objective of minimizing the potential risk of principal loss.

During the six months ended April 1, 2017, cash generated by operating activities of $39.6 billion was a result of $28.9 billion of net income, non-cash adjustments to net income of $10.4 billion and an increase in the net change in operating assets and liabilities of $0.3 billion. Cash used in investing activities of $33.3 billion during the six months ended April 1, 2017 consisted primarily of cash used for purchases of marketable securities, net of sales and maturities, of $26.9 billion and cash used to acquire property, plant and equipment of $6.3 billion. Cash used in financing activities of $11.6 billion during the six months ended April 1, 2017 consisted primarily of cash used to repurchase common stock of $18.0 billion and cash used to pay dividends and dividend equivalents of $6.1 billion, partially offset by proceeds from the issuance of term debt, net of $11.0 billion and a net increase in commercial paper of $1.9 billion.

During the six months ended March 26, 2016, cash generated by operating activities of $39.1 billion was a result of $28.9 billion of net income, non-cash adjustments to net income of $11.0 billion and a decrease in the net change in operating assets and liabilities of $0.8 billion. Cash used in investing activities of $34.1 billion during the six months ended March 26, 2016 consisted primarily of cash used for purchases of marketable securities, net of sales and maturities, of $27.0 billion and cash used to acquire property, plant and equipment of $5.9 billion. Cash used in financing activities of $4.6 billion during the six months ended March 26, 2016 consisted primarily of cash used to repurchase common stock of $13.5 billion and cash used to pay dividends and dividend equivalents of $5.9 billion, partially offset by proceeds from the issuance of term debt, net of $15.6 billion.

Capital Assets

The Company's capital expenditures were $4.5 billion during the first six months of 2017. The Company anticipates utilizing approximately $16.0 billion for capital expenditures during 2017, which includes product tooling and manufacturing process equipment; data centers; corporate facilities and infrastructure, including information systems hardware, software and enhancements; and retail store facilities.

Debt

The Company issues unsecured short-term promissory notes ("Commercial Paper") pursuant to a commercial paper program. The Company uses the net proceeds from the commercial paper program for general corporate purposes, including dividends and share repurchases. As of April 1, 2017, the Company had $10.0 billion of Commercial Paper outstanding, with a weighted-average interest rate of 0.80% and maturities generally less than nine months.

As of April 1, 2017, the Company had outstanding floating- and fixed-rate notes with varying maturities for an aggregate principal amount of $88.9 billion (collectively the "Notes"). The Company has entered, and in the future may enter, into interest rate swaps to manage interest rate risk on the Notes. In addition, the Company has entered, and in the future may enter, into currency swaps to manage foreign currency risk on the Notes.

Further information regarding the Company's debt issuances and related hedging activity can be found in Part I, Item 1 of this Form 10-Q in the Notes to Condensed Consolidated Financial Statements, in Note 2, "Financial Instruments" and Note 6, "Debt."

Capital Return Program
As of April 1, 2017, the Company had an authorized capital return program of $250 billion, which included a share repurchase program of $175 billion of the Company’s common stock. As of April 1, 2017, $151 billion of the share repurchase program had been utilized. The Company’s share repurchase program does not obligate it to acquire any specific number of shares. Under the program, shares may be repurchased in privately negotiated or open market transactions, including under plans complying with Rule 10b5-1 under the Exchange Act.

The following table presents the Company’s dividends, dividend equivalents, share repurchases and net share settlement activity from the start of the capital return program in August 2012 through April 1, 2017 (in millions):

	Dividends and Dividend Equivalents Paid	Accelerated Share Repurchases	Open Market Share Repurchases	Taxes Related to Settlement of Equity Awards	Total
Q2 2017	$ 3,004	$ 3,000	$ 4,001	$ 159	$10,164
Q1 2017	3,130	6,000	5,000	629	14,759
2016	12,150	12,000	17,000	1,570	42,720
2015	11,561	6,000	30,026	1,499	49,086
2014	11,126	21,000	24,000	1,158	57,284
2013	10,564	13,950	9,000	1,082	34,596
2012	2,488	—	—	56	2,544
Total	$ 54,023	$ 61,950	$ 89,027	$ 6,153	$211,153

On May 2, 2017, the Company announced that the Board of Directors increased the total capital return program from $250 billion to $300 billion, which includes an increase in the share repurchase authorization from $175 billion to $210 billion. Additionally, the Company announced that the Board of Directors raised the Company's quarterly cash dividend by 10.5% from $0.57 to $0.63 per share, beginning with the dividend to be paid during the third quarter of 2017. The Company intends to increase its dividend on an annual basis subject to declaration by the Board of Directors.

The Company expects to execute its capital return program by the end of March 2019 by paying dividends and dividend equivalents, repurchasing shares and remitting withheld taxes related to net share settlement of restricted stock units. The Company plans to continue to access the domestic and international debt markets to assist in funding its capital return program.

Off-Balance Sheet Arrangements and Contractual Obligations

The Company has not entered into any transactions with unconsolidated entities whereby the Company has financial guarantees, subordinated retained interests, derivative instruments, or other contingent arrangements that expose the Company to material continuing risks, contingent liabilities, or any other obligation under a variable interest in an unconsolidated entity that provides financing, liquidity, market risk, or credit risk support to the Company, or engages in leasing, hedging, or R&D services with the Company.

Operating Leases

As of April 1, 2017, the Company’s total future minimum lease payments under noncancelable operating leases were $8.2 billion. The Company’s retail store and other facility leases are typically for terms not exceeding 10 years and generally contain multi-year renewal options.

Manufacturing Purchase Obligations

The Company utilizes several outsourcing partners to manufacture sub-assemblies for the Company’s products and to perform final assembly and testing of finished products. These outsourcing partners acquire components and build product based on demand information supplied by the Company, which typically covers periods up to 150 days. The Company also obtains individual components for its products from a wide variety of individual suppliers. Consistent with industry practice, the Company acquires components through a combination of purchase orders, supplier contracts, and open orders based on projected demand information. As of April 1, 2017, the Company had manufacturing purchase obligations of $21.7 billion.

Other Purchase Obligations

The Company’s other purchase obligations were comprised of commitments to acquire capital assets, including product tooling and manufacturing process equipment, and commitments related to advertising, licensing, R&D, internet and telecommunications services and other obligations. As of April 1, 2017, the Company had other purchase obligations of $5.9 billion.

The Company’s other non-current liabilities in the Condensed Consolidated Balance Sheets consist primarily of deferred tax liabilities, gross unrecognized tax benefits and the related gross interest and penalties. As of April 1, 2017, the Company had non-current deferred tax liabilities of $28.2 billion, gross unrecognized tax benefits of $8.8

billion and an additional $1.3 billion for gross interest and penalties.

Indemnification

The Company generally does not indemnify end-users of its operating system and application software against legal claims that the software infringes third-party intellectual property rights. Other agreements entered into by the Company sometimes include indemnification provisions under which the Company could be subject to costs and/or damages in the event of an infringement claim against the Company or an indemnified third party. In the opinion of management, there was not at least a reasonable possibility the Company may have incurred a material loss with respect to indemnification of end-users of its operating system or application software for infringement of third-party intellectual property rights.

The Company offers an iPhone Upgrade Program, which is available to customers who purchase a qualifying iPhone in the U.S., the U.K. and mainland China. The iPhone Upgrade Program provides customers the right to trade in that iPhone for a specified amount when purchasing a new iPhone, provided certain conditions are met. The Company accounts for the trade-in right as a guarantee liability and recognizes arrangement revenue net of the fair value of such right with subsequent changes to the guarantee liability recognized within revenue.

The Company has entered into indemnification agreements with its directors and executive officers. Under these agreements, the Company has agreed to indemnify such individuals to the fullest extent permitted by law against liabilities that arise by reason of their status as directors or officers and to advance expenses incurred by such individuals in connection with related legal proceedings. It is not possible to determine the maximum potential amount of payments the Company could be required to make under these agreements due to the limited history of prior indemnification claims and the unique facts and circumstances involved in each claim. However, the Company maintains directors and officers liability insurance coverage to reduce its exposure to such obligations.

Critical Accounting Policies and Estimates

The preparation of financial statements and related disclosures in conformity with U.S. generally accepted accounting principles and the Company's discussion and analysis of its financial condition and operating results require the Company's management to make judgments, assumptions and estimates that affect the amounts reported in its condensed consolidated financial statements and accompanying notes. Management bases its estimates on historical experience and on various other assumptions it believes to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities. Actual results may differ from these estimates, and such differences may be material.

Note 1, "Summary of Significant Accounting Policies" in Part I, Item 1 of this Form 10-Q and in the Notes to Consolidated Financial Statements in Part II, Item 8 of the 2016 Form 10-K, and "Critical Accounting Policies and Estimates" in Part II, Item 7 of the 2016 Form 10-K describe the significant accounting policies and methods used in the preparation of the Company's condensed consolidated financial statements. There have been no material changes to the Company's critical accounting policies and estimates since the 2016 Form 10-K.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

There have been no material changes to the Company's market risk during the first six months of 2017. For a discussion of the Company's exposure to market risk, refer to the Company's market risk disclosures set forth in Part II, Item 7A, "Quantitative and Qualitative Disclosures About Market Risk" of the 2016 Form 10-K.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Based on an evaluation under the supervision and with the participation of the Company's management, the Company's principal executive officer and principal financial officer have concluded that the Company's disclosure controls and procedures as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act were effective as of April 1, 2017 to ensure that information required to be disclosed by the Company in reports that it files or submits under the Exchange Act is (i) recorded, processed, summarized and reported within the time periods specified in the SEC rules and forms and (ii) accumulated and communicated to the Company's management, including its principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

Changes in Internal Control Over Financial Reporting

There were no changes in the Company's internal control over financial reporting during the second quarter of 2017, which were identified in connection with management's evaluation required by paragraph (d) of Rules 13a-15 and

15d-15 under the Exchange Act, that have materially affected, or are reasonably likely to materially affect, the Company’s internal control over financial reporting.

PART II — OTHER INFORMATION

Item 1. Legal Proceedings

The Company is subject to legal proceedings and claims that have not been fully resolved and that have arisen in the ordinary course of business. In the opinion of management, there was not at least a reasonable possibility the Company may have incurred a material loss, or a material loss in excess of a recorded accrual, with respect to loss contingencies for asserted legal and other claims. However, the outcome of legal proceedings and claims brought against the Company is subject to significant uncertainty. Therefore, although management considers the likelihood of such an outcome to be remote, if one or more of these legal matters were resolved against the Company in a reporting period for amounts in excess of management's expectations, the Company's consolidated financial statements for that reporting period could be materially adversely affected. See the risk factor "The Company could be impacted by unfavorable results of legal proceedings, such as being found to have infringed on intellectual property rights" in Part II, Item 1A of this Form 10-Q under the heading "Risk Factors." The Company settled certain matters during the second quarter of 2017 that did not individually or in the aggregate have a material impact on the Company's financial condition or operating results.

Item 1A. Risk Factors

The following description of risk factors includes any material changes to, and supersedes the description of, risk factors associated with the Company's business previously disclosed in Part I, Item 1A of the 2016 Form 10-K and in Part II, Item 1A of the Form 10-Q for the quarter ended December 31, 2016, in each case under the heading "Risk Factors." The business, financial condition and operating results of the Company can be affected by a number of factors, whether currently known or unknown, including but not limited to those described below, any one or more of which could, directly or indirectly, cause the Company's actual financial condition and operating results to vary materially from past, or from anticipated future, financial condition and operating results. Any of these factors, in whole or in part, could materially and adversely affect the Company's business, financial condition, operating results and stock price.

The following discussion of risk factors contains forward-looking statements. These risk factors may be important to understanding other statements in this Form 10-Q. The following information should be read in conjunction with the condensed consolidated financial statements and related notes in Part I, Item 1, "Financial Statements" and Part I, Item 2, "Management's Discussion and Analysis of Financial Condition and Results of Operations" of this Form 10-Q.

Because of the following factors, as well as other factors affecting the Company's financial condition and operating results, past financial performance should not be considered to be a reliable indicator of future performance, and investors should not use historical trends to anticipate results or trends in future periods.

Global and regional economic conditions could materially adversely affect the Company.

The Company's operations and performance depend significantly on global and regional economic conditions. Uncertainty about global and regional economic conditions poses a risk as consumers and businesses may postpone spending in response to tighter credit, higher unemployment, financial market volatility, government austerity programs, negative financial news, declines in income or asset values and/or other factors. These worldwide and regional economic conditions could have a material adverse effect on demand for the Company's products and services. Demand also could differ materially from the Company's expectations as a result of currency fluctuations because the Company generally raises prices on goods and services sold outside the U.S. to correspond with the effect of a strengthening of the U.S. dollar. Other factors that could influence worldwide or regional demand include changes in fuel and other energy costs, conditions in the real estate and mortgage markets, unemployment, labor and healthcare costs, access to credit, consumer confidence and other macroeconomic factors affecting consumer spending behavior. These and other economic factors could materially adversely affect demand for the Company's products and services.

In the event of financial turmoil affecting the banking system and financial markets, additional consolidation of the financial services industry, or significant financial service institution failures, there could be tightening in the credit markets, low liquidity and extreme volatility in fixed income, credit, currency and equity markets. This could have a number of effects on the Company's business, including the insolvency or financial instability of outsourcing partners or suppliers or their inability to obtain credit to finance development and/or manufacture products resulting in product delays; inability of customers, including channel partners, to obtain credit to finance purchases of the

Company's products; failure of derivative counterparties and other financial institutions; and restrictions on the Company's ability to issue new debt. Other income and expense also could vary materially from expectations depending on gains or losses realized on the sale or exchange of financial instruments; impairment charges resulting from revaluations of debt and equity securities and other investments; changes in interest rates; increases or decreases in cash balances; volatility in foreign exchange rates; and changes in fair value of derivative instruments. Increased volatility in the financial markets and overall economic uncertainty would increase the risk of the actual amounts realized in the future on the Company's financial instruments differing significantly from the fair values currently assigned to them.

Global markets for the Company’s products and services are highly competitive and subject to rapid technological change, and the Company may be unable to compete effectively in these markets.
The Company’s products and services compete in highly competitive global markets characterized by aggressive price cutting and resulting downward pressure on gross margins, frequent introduction of new products, short product life cycles, evolving industry standards, continual improvement in product price/performance characteristics, rapid adoption of technological and product advancements by competitors and price sensitivity on the part of consumers.
The Company’s ability to compete successfully depends heavily on its ability to ensure a continuing and timely introduction of innovative new products, services and technologies to the marketplace. The Company believes it is unique in that it designs and develops nearly the entire solution for its products, including the hardware, operating system, numerous software applications and related services. As a result, the Company must make significant investments in R&D. The Company currently holds a significant number of patents and copyrights and has registered and/or has applied to register numerous patents, trademarks and service marks. In contrast, many of the Company’s competitors seek to compete primarily through aggressive pricing and very low cost structures, and emulating the Company's products and infringing on its intellectual property. If the Company is unable to continue to develop and sell innovative new products with attractive margins or if competitors infringe on the Company’s intellectual property, the Company’s ability to maintain a competitive advantage could be adversely affected.
The Company markets certain mobile communication and media devices based on the iOS mobile operating system and also markets related services, including third-party digital content and applications. The Company faces substantial competition in these markets from companies that have significant technical, marketing, distribution and other resources, as well as established hardware, software and digital content supplier relationships; and the Company has a minority market share in the global smartphone market. Additionally, the Company faces significant price competition as competitors reduce their selling prices and attempt to imitate the Company’s product features and applications within their own products or, alternatively, collaborate with each other to offer solutions that are more competitive than those they currently offer. The Company competes with business models that provide content to users for free. The Company also competes with illegitimate means to obtain third-party digital content and applications. Some of the Company’s competitors have greater experience, product breadth and distribution channels than the Company. Because some current and potential competitors have substantial resources and/or experience and a lower cost structure, they may be able to provide products and services at little or no profit or even at a loss. The Company also expects competition to intensify as competitors attempt to imitate the Company’s approach to providing components seamlessly within their individual offerings or work collaboratively to offer integrated solutions. The Company’s financial condition and operating results depend substantially on the Company’s ability to continually improve iOS and iOS devices in order to maintain their functional and design advantages.
The Company is the only authorized maker of hardware using macOS, which has a minority market share in the personal computer market. This market has been contracting and is dominated by computer makers using competing operating systems, most notably Windows. In the market for personal computers and accessories, the Company faces a significant number of competitors, many of which have broader product lines, lower-priced products and a larger installed customer base. Historically, consolidation in this market has resulted in larger competitors. Price competition has been particularly intense as competitors have aggressively cut prices and lowered product margins. An increasing number of internet-enabled devices that include software applications and are smaller and simpler than traditional personal computers compete for market share with the Company’s existing products. The Company’s financial condition and operating results also depend on its ability to continually improve the Mac platform to maintain its functional and design advantages.
There can be no assurance the Company will be able to continue to provide products and services that compete effectively.
To remain competitive and stimulate customer demand, the Company must successfully manage frequent product introductions and transitions.
Due to the highly volatile and competitive nature of the industries in which the Company competes, the Company must continually introduce new products, services and technologies, enhance existing products and services, effectively stimulate customer demand for new and upgraded products and successfully manage the transition to these new and upgraded products. The success of new product introductions depends on a number of factors including, but

not limited to, timely and successful product development, market acceptance, the Company’s ability to manage the risks associated with new product production ramp-up issues, the availability of application software for new products, the effective management of purchase commitments and inventory levels in line with anticipated product demand, the availability of products in appropriate quantities and at expected costs to meet anticipated demand and the risk that new products may have quality or other defects or deficiencies in the early stages of introduction. Accordingly, the Company cannot determine in advance the ultimate effect of new product introductions and transitions.

The Company depends on the performance of distributors, carriers and other resellers.
The Company distributes its products through cellular network carriers, wholesalers, national and regional retailers and value-added resellers, many of whom distribute products from competing manufacturers. The Company also sells its products and third-party products in most of its major markets directly to education, enterprise and government customers and consumers and small and mid-sized businesses through its retail and online stores.
Some carriers providing cellular network service for iPhone subsidize users' purchases of the device. There is no assurance that such subsidies will be continued at all or in the same amounts upon renewal of the Company's agreements with these carriers or in agreements the Company enters into with new carriers.
The Company has invested and will continue to invest in programs to enhance reseller sales, including staffing selected resellers' stores with Company employees and contractors, and improving product placement displays. These programs could require a substantial investment while providing no assurance of return or incremental revenue. The financial condition of these resellers could weaken, these resellers could stop distributing the Company's products, or uncertainty regarding demand for some or all of the Company's products could cause resellers to reduce their ordering and marketing of the Company's products.
The Company faces substantial inventory and other asset risk in addition to purchase commitment cancellation risk.
The Company records a write-down for product and component inventories that have become obsolete or exceed anticipated demand or net realizable value and accrues necessary cancellation fee reserves for orders of excess products and components. The Company also reviews its long-lived assets, including capital assets held at its suppliers' facilities and inventory prepayments, for impairment whenever events or circumstances indicate the carrying amount of an asset may not be recoverable. If the Company determines that impairment has occurred, it records a write-down equal to the amount by which the carrying value of the assets exceeds its fair value. Although the Company believes its provisions related to inventory, capital assets, inventory prepayments and other assets and purchase commitments are currently adequate, no assurance can be given that the Company will not incur additional related charges given the rapid and unpredictable pace of product obsolescence in the industries in which the Company competes.
The Company must order components for its products and build inventory in advance of product announcements and shipments. Consistent with industry practice, components are normally acquired through a combination of purchase orders, supplier contracts and open orders, in each case based on projected demand. Manufacturing purchase obligations typically cover forecasted component and manufacturing requirements for periods up to 150 days. Because the Company's markets are volatile, competitive and subject to rapid technology and price changes, there is a risk the Company will forecast incorrectly and order or produce excess or insufficient amounts of components or products, or not fully utilize firm purchase commitments.
Future operating results depend upon the Company's ability to obtain components in sufficient quantities on commercially reasonable terms.
Because the Company currently obtains components from single or limited sources, the Company is subject to significant supply and pricing risks. Many components, including those that are available from multiple sources, are at times subject to industry-wide shortages and significant commodity pricing fluctuations. While the Company has entered into agreements for the supply of many components, there can be no assurance that the Company will be able to extend or renew these agreements on similar terms, or at all. A number of suppliers of components may suffer from poor financial conditions, which can lead to business failure for the supplier or consolidation within a particular industry, further limiting the Company's ability to obtain sufficient quantities of components on commercially reasonable terms. The effects of global or regional economic conditions on the Company's suppliers, described in "Global and regional economic conditions could materially adversely affect the Company" above, also could affect the Company's ability to obtain components. Therefore, the Company remains subject to significant risks of supply shortages and price increases.
The Company's new products often utilize custom components available from only one source. When a component or product uses new technologies, initial capacity constraints may exist until the suppliers' yields have matured or manufacturing capacity has increased. Continued availability of these components at acceptable prices, or at all, may be affected for any number of reasons, including if those suppliers decide to concentrate on the production of common components instead of components customized to meet the Company's requirements. The supply of components for a

new or existing product could be delayed or constrained, or a key manufacturing vendor could delay shipments of completed products to the Company.

The Company depends on component and product manufacturing and logistical services provided by outsourcing partners, many of which are located outside of the U.S.
Substantially all of the Company's manufacturing is performed in whole or in part by a few outsourcing partners located primarily in Asia. The Company has also outsourced much of its transportation and logistics management. While these arrangements may lower operating costs, they also reduce the Company's direct control over production and distribution. It is uncertain what effect such diminished control will have on the quality or quantity of products or services, or the Company's flexibility to respond to changing conditions. Although arrangements with these partners may contain provisions for warranty expense reimbursement, the Company may remain responsible to the consumer for warranty service in the event of product defects and could experience an unanticipated product defect or warranty liability. While the Company relies on its partners to adhere to its supplier code of conduct, material violations of the supplier code of conduct could occur.
The Company relies on sole-sourced outsourcing partners in the U.S., Asia and Europe to supply and manufacture many critical components, and on outsourcing partners primarily located in Asia, for final assembly of substantially all of the Company's hardware products. Any failure of these partners to perform may have a negative impact on the Company's cost or supply of components or finished goods. In addition, manufacturing or logistics in these locations or transit to final destinations may be disrupted for a variety of reasons including, but not limited to, natural and man-made disasters, information technology system failures, commercial disputes, military actions or economic, business, labor, environmental, public health, or political issues.
The Company has invested in manufacturing process equipment, much of which is held at certain of its outsourcing partners, and has made prepayments to certain of its suppliers associated with long-term supply agreements. While these arrangements help ensure the supply of components and finished goods, if these outsourcing partners or suppliers experience severe financial problems or other disruptions in their business, such continued supply could be reduced or terminated and the net realizable value of these assets could be negatively impacted.
The Company's products and services may experience quality problems from time to time that can result in decreased sales and operating margin and harm to the Company's reputation.
The Company sells complex hardware and software products and services that can contain design and manufacturing defects. Sophisticated operating system software and applications, such as those sold by the Company, often contain "bugs" that can unexpectedly interfere with the software's intended operation. The Company's online services may from time to time experience outages, service slowdowns, or errors. Defects may also occur in components and products the Company purchases from third parties. There can be no assurance the Company will be able to detect and fix all defects in the hardware, software and services it sells. Failure to do so could result in lost revenue, significant warranty and other expenses and harm to the Company's reputation.
The Company relies on access to third-party digital content, which may not be available to the Company on commercially reasonable terms or at all.
The Company contracts with numerous third parties to offer their digital content to customers. This includes the right to sell currently available music, movies, TV shows and books. The licensing or other distribution arrangements with these third parties are for relatively short terms and do not guarantee the continuation or renewal of these arrangements on reasonable terms, if at all. Some third-party content providers and distributors currently or in the future may offer competing products and services, and could take action to make it more difficult or impossible for the Company to license or otherwise distribute their content in the future. Other content owners, providers or distributors may seek to limit the Company's access to, or increase the cost of, such content. The Company may be unable to continue to offer a wide variety of content at reasonable prices with acceptable usage rules, or continue to expand its geographic reach. Failure to obtain the right to make available third-party digital content, or to make available such content on commercially reasonable terms, could have a material adverse impact on the Company's financial condition and operating results.
Some third-party digital content providers require the Company to provide digital rights management and other security solutions. If requirements change, the Company may have to develop or license new technology to provide these solutions. There is no assurance the Company will be able to develop or license such solutions at a reasonable cost and in a timely manner. In addition, certain countries have passed or may propose and adopt legislation that would force the Company to license its digital rights management, which could lessen the protection of content and

subject it to piracy and also could negatively affect arrangements with the Company’s content providers.

The Company’s future performance depends in part on support from third-party software developers.
The Company believes decisions by customers to purchase its hardware products depend in part on the availability of third party software applications and services. There is no assurance that third-party developers will continue to develop and maintain software applications and services for the Company’s products. If third-party software applications and services cease to be developed and maintained for the Company’s products, customers may choose not to buy the Company’s products.
With respect to its Mac products, the Company believes the availability of third party software applications and services depends in part on the developers’ perception and analysis of the relative benefits of developing, maintaining and upgrading such software for the Company’s products compared to Windows-based products. This analysis may be based on factors such as the market position of the Company and its products, the anticipated revenue that may be generated, expected future growth of Mac sales and the costs of developing such applications and services. If the Company’s minority share of the global personal computer market causes developers to question the Mac’s prospects, developers could be less inclined to develop or upgrade software for the Company’s Mac products and more inclined to devote their resources to developing and upgrading software for the larger Windows market.
With respect to iOS devices, the Company relies on the continued availability and development of compelling and innovative software applications, including applications distributed through the App Store. iOS devices are subject to rapid technological change, and, if third-party developers are unable to or choose not to keep up with this pace of change, third-party applications might not successfully operate and may result in dissatisfied customers. As with applications for the Company’s Mac products, the availability and development of these applications also depend on developers’ perceptions and analysis of the relative benefits of developing, maintaining or upgrading software for the Company’s iOS devices rather than its competitors’ platforms, such as Android. If developers focus their efforts on these competing platforms, the availability and quality of applications for the Company’s iOS devices may suffer.
The Company relies on access to third-party intellectual property, which may not be available to the Company on commercially reasonable terms or at all.
Many of the Company’s products include third-party intellectual property, which requires licenses from those third parties. Based on past experience and industry practice, the Company believes such licenses generally can be obtained on reasonable terms. There is, however, no assurance that the necessary licenses can be obtained on acceptable terms or at all. Failure to obtain the right to use third-party intellectual property, or to use such intellectual property on commercially reasonable terms, could preclude the Company from selling certain products or otherwise have a material adverse impact on the Company’s financial condition and operating results.
The Company could be impacted by unfavorable results of legal proceedings, such as being found to have infringed on intellectual property rights.
The Company is subject to various legal proceedings and claims that have not yet been fully resolved and that have arisen in the ordinary course of business, and additional claims may arise in the future.
For example, technology companies, including many of the Company’s competitors, frequently enter into litigation based on allegations of patent infringement or other violations of intellectual property rights. In addition, patent holding companies seek to monetize patents they have purchased or otherwise obtained. The intellectual property rights claims against the Company have generally increased over time and may continue to increase. In particular, the Company's cellular-enabled products compete with products from mobile communication and media device companies that hold significant patent portfolios, and the Company has faced a significant number of patent claims against it. The Company is vigorously defending infringement actions in courts in a number of U.S. jurisdictions and before the U.S. International Trade Commission, as well as internationally in various countries. The plaintiffs in these actions frequently seek injunctions and substantial damages.
Regardless of the scope or validity of such patents or other intellectual property rights, or the merits of any claims by potential or actual litigants, the Company may have to engage in protracted litigation. If the Company is found to infringe one or more patents or other intellectual property rights, regardless of whether it can develop non-infringing technology, it may be required to pay substantial damages or royalties to a third party, or it may be subject to a temporary or permanent injunction prohibiting the Company from marketing or selling certain products.
In certain cases, the Company may consider the desirability of entering into licensing agreements, although no assurance can be given that such licenses can be obtained on acceptable terms or that litigation will not occur. These

licenses may also significantly increase the Company's operating expenses.

Regardless of the merit of particular claims, litigation may be expensive, time-consuming, disruptive to the Company's operations and distracting to management. In recognition of these considerations, the Company may enter into arrangements to settle litigation.

In management's opinion, there is not at least a reasonable possibility the Company may have incurred a material loss, or a material loss in excess of a recorded accrual, with respect to loss contingencies, including matters related to infringement of intellectual property rights. However, the outcome of litigation is inherently uncertain.

Although management considers the likelihood of such an outcome to be remote, if one or more legal matters were resolved against the Company in a reporting period for amounts in excess of management's expectations, the Company's consolidated financial statements for that reporting period could be materially adversely affected. Further, such an outcome could result in significant compensatory, punitive or trebled monetary damages, disgorgement of revenue or profits, remedial corporate measures or injunctive relief against the Company that could materially adversely affect its financial condition and operating results.

The Company is subject to laws and regulations worldwide, changes to which could increase the Company's costs and individually or in the aggregate adversely affect the Company's business.

The Company is subject to laws and regulations affecting its domestic and international operations in a number of areas. These U.S. and foreign laws and regulations affect the Company's activities including, but not limited to, in areas of labor, advertising, digital content, consumer protection, real estate, billing, e-commerce, promotions, quality of services, telecommunications, mobile communications and media, television, intellectual property ownership and infringement, tax, import and export requirements, anti-corruption, foreign exchange controls and cash repatriation restrictions, data privacy requirements, anti-competition, environmental, health and safety.

By way of example, laws and regulations related to mobile communications and media devices in the many jurisdictions in which the Company operates are extensive and subject to change. Such changes could include, among others, restrictions on the production, manufacture, distribution and use of devices, locking devices to a carrier's network, or mandating the use of devices on more than one carrier's network. These devices are also subject to certification and regulation by governmental and standardization bodies, as well as by cellular network carriers for use on their networks. These certification processes are extensive and time consuming, and could result in additional testing requirements, product modifications, or delays in product shipment dates, or could preclude the Company from selling certain products.

Compliance with these laws, regulations and similar requirements may be onerous and expensive, and they may be inconsistent from jurisdiction to jurisdiction, further increasing the cost of compliance and doing business. Any such costs, which may rise in the future as a result of changes in these laws and regulations or in their interpretation, could individually or in the aggregate make the Company's products and services less attractive to the Company's customers, delay the introduction of new products in one or more regions, or cause the Company to change or limit its business practices. The Company has implemented policies and procedures designed to ensure compliance with applicable laws and regulations, but there can be no assurance that the Company's employees, contractors, or agents will not violate such laws and regulations or the Company's policies and procedures.

The Company's business is subject to the risks of international operations.

The Company derives a significant portion of its revenue and earnings from its international operations. Compliance with applicable U.S. and foreign laws and regulations, such as import and export requirements, anti-corruption laws, tax laws, foreign exchange controls and cash repatriation restrictions, data privacy requirements, environmental laws, labor laws and anti-competition regulations, increases the costs of doing business in foreign jurisdictions. Although the Company has implemented policies and procedures to comply with these laws and regulations, a violation by the Company's employees, contractors, or agents could nevertheless occur. In some cases, compliance with the laws and regulations of one country could violate the laws and regulations of another country. Violations of these laws and regulations could materially adversely affect the Company's brand, international growth efforts and business.

The Company also could be significantly affected by other risks associated with international activities including, but not limited to, economic and labor conditions, increased duties, taxes and other costs and political instability. Margins on sales of the Company's products in foreign countries, and on sales of products that include components obtained from foreign suppliers, could be materially adversely affected by international trade regulations, including duties, tariffs and antidumping penalties. The Company is also exposed to credit and collectability risk on its trade

receivables with customers in certain international markets. There can be no assurance the Company can effectively limit its credit risk and avoid losses.

The Company’s retail stores have required and will continue to require a substantial investment and commitment of resources and are subject to numerous risks and uncertainties.

The Company’s retail stores have required substantial investment in equipment and leasehold improvements, information systems, inventory and personnel. The Company also has entered into substantial operating lease commitments for retail space. Certain stores have been designed and built to serve as high-profile venues to promote brand awareness and serve as vehicles for corporate sales and marketing activities. Because of their unique design elements, locations and size, these stores require substantially more investment than the Company’s more typical retail stores. Due to the high cost structure associated with the Company’s retail stores, a decline in sales or the closure or poor performance of individual or multiple stores could result in significant lease termination costs, write-offs of equipment and leasehold improvements and severance costs.

Many factors unique to retail operations, some of which are beyond the Company’s control, pose risks and uncertainties. These risks and uncertainties include, but are not limited to, macro-economic factors that could have an adverse effect on general retail activity, as well as the Company’s inability to manage costs associated with store construction and operation, the Company’s failure to manage relationships with its existing retail partners, more challenging environments in managing retail operations outside the U.S., costs associated with unanticipated fluctuations in the value of retail inventory, and the Company’s inability to obtain and renew leases in quality retail locations at a reasonable cost.

Investment in new business strategies and acquisitions could disrupt the Company’s ongoing business and present risks not originally contemplated.

The Company has invested, and in the future may invest, in new business strategies or acquisitions. Such endeavors may involve significant risks and uncertainties, including distraction of management from current operations, greater than expected liabilities and expenses, inadequate return of capital and unidentified issues not discovered in the Company’s due diligence. These new ventures are inherently risky and may not be successful.

The Company’s business and reputation may be impacted by information technology system failures or network disruptions.

The Company may be subject to information technology system failures and network disruptions. These may be caused by natural disasters, accidents, power disruptions, telecommunications failures, acts of terrorism or war, computer viruses, physical or electronic break-ins, or other events or disruptions. System redundancy may be ineffective or inadequate, and the Company’s disaster recovery planning may not be sufficient for all eventualities. Such failures or disruptions could, among other things, prevent access to the Company’s online stores and services, preclude retail store transactions, compromise Company or customer data, and result in delayed or cancelled orders. System failures and disruptions could also impede the manufacturing and shipping of products, delivery of online services, transactions processing and financial reporting.

There may be breaches of the Company’s information technology systems that materially damage business partner and customer relationships, curtail or otherwise adversely impact access to online stores and services, or subject the Company to significant reputational, financial, legal and operational consequences.

The Company’s business requires it to use and store customer, employee and business partner personally identifiable information (“PII”). This may include, among other information, names, addresses, phone numbers, email addresses, contact preferences, tax identification numbers and payment account information. Although malicious attacks to gain access to PII affect many companies across various industries, the Company is at a relatively greater risk of being targeted because of its high profile and the amount of PII it manages.

The Company requires user names and passwords in order to access its information technology systems. The Company also uses encryption and authentication technologies designed to secure the transmission and storage of data and prevent access to Company data or accounts. As with all companies, these security measures are subject to third-party security breaches, employee error, malfeasance, faulty password management or other irregularities. For example, third parties may attempt to fraudulently induce employees or customers into disclosing user names, passwords or other sensitive information, which may in turn be used to access the Company’s information technology systems. To help protect customers and the Company, the Company monitors accounts and systems for unusual activity and may freeze accounts under suspicious circumstances, which may result in the delay or loss of customer orders.

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The Company devotes significant resources to network security, data encryption and other security measures to protect its systems and data, but these security measures cannot provide absolute security. To the extent the Company was to experience a breach of its systems and was unable to protect sensitive data, such a breach could materially damage business partner and customer relationships, and curtail or otherwise adversely impact access to online stores and services. Moreover, if a computer security breach affects the Company's systems or results in the unauthorized release of PII, the Company's reputation and brand could be materially damaged, use of the Company's products and services could decrease, and the Company could be exposed to a risk of loss or litigation and possible liability. While the Company maintains insurance coverage that, subject to policy terms and conditions and subject to a significant self-insured retention, is designed to address certain aspects of cyber risks, such insurance coverage may be insufficient to cover all losses or all types of claims that may arise in the continually evolving area of cyber risk.
The Company is also subject to payment card association rules and obligations under its contracts with payment card processors. Under these rules and obligations, if information is compromised, the Company could be liable to payment card issuers for associated expenses and penalties. In addition, if the Company fails to follow payment card industry security standards, even if no customer information is compromised, the Company could incur significant fines or experience a significant increase in payment card transaction costs.
The Company's business is subject to a variety of U.S. and international laws, rules, policies and other obligations regarding data protection.
The Company is subject to federal, state and international laws relating to the collection, use, retention, security and transfer of PII. In many cases, these laws apply not only to third-party transactions, but also may restrict transfers of PII among the Company and its international subsidiaries. Several jurisdictions have passed laws in this area, and other jurisdictions are considering imposing additional restrictions. These laws continue to develop and may be inconsistent from jurisdiction to jurisdiction. Complying with emerging and changing international requirements may cause the Company to incur substantial costs or require the Company to change its business practices. Noncompliance could result in significant penalties or legal liability.
The Company makes statements about its use and disclosure of PII through its privacy policy, information provided on its website and press statements. Any failure by the Company to comply with these public statements or with other federal, state or international privacy-related or data protection laws and regulations could result in proceedings against the Company by governmental entities or others. Penalties could include ongoing audit requirements or significant legal liability.
The Company's success depends largely on the continued service and availability of key personnel.
Much of the Company's future success depends on the continued availability and service of key personnel, including its Chief Executive Officer, executive team and other highly skilled employees. Experienced personnel in the technology industry are in high demand and competition for their talents is intense, especially in Silicon Valley, where most of the Company's key personnel are located.
The Company's business may be impacted by political events, war, terrorism, public health issues, natural disasters and other business interruptions.
War, terrorism, geopolitical uncertainties, public health issues and other business interruptions have caused and could cause damage or disruption to international commerce and the global economy, and thus could have a material adverse effect on the Company, its suppliers, logistics providers, manufacturing vendors and customers, including channel partners. The Company's business operations are subject to interruption by, among others, natural disasters, whether as a result of climate change or otherwise, fire, power shortages, nuclear power plant accidents and other industrial accidents, terrorist attacks and other hostile acts, labor disputes, public health issues and other events beyond its control. Such events could decrease demand for the Company's products, make it difficult or impossible for the Company to make and deliver products to its customers, including channel partners, or to receive components from its suppliers, and create delays and inefficiencies in the Company's supply chain. While the Company's suppliers are required to maintain safe working environments and operations, an industrial accident could occur and could result in disruption to the Company's business and harm to the Company's reputation. Should major public health issues, including pandemics, arise, the Company could be adversely affected by more stringent employee travel restrictions, additional limitations in freight services, governmental actions limiting the movement of products between regions, delays in production ramps of new products and disruptions in the operations of the Company's manufacturing vendors

and component suppliers. The majority of the Company’s R&D activities, its corporate headquarters, information technology systems and other critical business operations, including certain component suppliers and manufacturing vendors, are in locations that could be affected by natural disasters. In the event of a natural disaster, the Company could incur significant losses, require substantial recovery time and experience significant expenditures in order to resume operations.

The Company expects its quarterly revenue and operating results to fluctuate.

The Company’s profit margins vary across its products and distribution channels. The Company’s software, accessories, and service and support contracts generally have higher gross margins than certain of the Company’s other products. Gross margins on the Company’s hardware products vary across product lines and can change over time as a result of product transitions, pricing and configuration changes, and component, warranty, and other cost fluctuations. The Company’s direct sales generally have higher associated gross margins than its indirect sales through its channel partners. In addition, the Company’s gross margin and operating margin percentages, as well as overall profitability, may be materially adversely impacted as a result of a shift in product, geographic or channel mix, component cost increases, the strengthening U.S. dollar, price competition, or the introduction of new products, including those that have higher cost structures with flat or reduced pricing.

The Company has typically experienced higher net sales in its first quarter compared to other quarters due in part to seasonal holiday demand. Additionally, new product introductions can significantly impact net sales, product costs and operating expenses. Further, the Company generates a majority of its net sales from a single product and a decline in demand for that product could significantly impact quarterly net sales. The Company could also be subject to unexpected developments late in a quarter, such as lower-than-anticipated demand for the Company’s products, issues with new product introductions, an internal systems failure, or failure of one of the Company’s logistics, components supply, or manufacturing partners.

The Company’s stock price is subject to volatility.

The Company’s stock price has experienced substantial price volatility in the past and may continue to do so in the future. Additionally, the Company, the technology industry and the stock market as a whole have experienced extreme stock price and volume fluctuations that have affected stock prices in ways that may have been unrelated to these companies’ operating performance. Price volatility over a given period may cause the average price at which the Company repurchases its own stock to exceed the stock’s price at a given point in time. The Company believes its stock price should reflect expectations of future growth and profitability. The Company also believes its stock price should reflect expectations that its cash dividend will continue at current levels or grow and that its current share repurchase program will be fully consummated. Future dividends are subject to declaration by the Company’s Board of Directors, and the Company’s share repurchase program does not obligate it to acquire any specific number of shares. If the Company fails to meet expectations related to future growth, profitability, dividends, share repurchases or other market expectations, its stock price may decline significantly, which could have a material adverse impact on investor confidence and employee retention.

The Company’s financial performance is subject to risks associated with changes in the value of the U.S. dollar versus local currencies.

The Company’s primary exposure to movements in foreign currency exchange rates relates to non-U.S. dollar-denominated sales and operating expenses worldwide. Weakening of foreign currencies relative to the U.S. dollar adversely affects the U.S. dollar value of the Company’s foreign currency-denominated sales and earnings, and generally leads the Company to raise international pricing, potentially reducing demand for the Company’s products. Margins on sales of the Company’s products in foreign countries and on sales of products that include components obtained from foreign suppliers, could be materially adversely affected by foreign currency exchange rate fluctuations. In some circumstances, for competitive or other reasons, the Company may decide not to raise local prices to fully offset the dollar’s strengthening, or at all, which would adversely affect the U.S. dollar value of the Company’s foreign currency-denominated sales and earnings. Conversely, a strengthening of foreign currencies relative to the U.S. dollar, while generally beneficial to the Company’s foreign currency-denominated sales and earnings, could cause the Company to reduce international pricing and incur losses on its foreign currency derivative instruments, thereby limiting the benefit. Additionally, strengthening of foreign currencies may also increase the Company’s cost of product components denominated in those currencies, thus adversely affecting gross margins.

The Company uses derivative instruments, such as foreign currency forward and option contracts, to hedge certain exposures to fluctuations in foreign currency exchange rates. The use of such hedging activities may not offset any, or more than a portion, of the adverse financial effects of unfavorable movements in foreign exchange rates over the limited time the hedges are in place.

The Company is exposed to credit risk and fluctuations in the market values of its investment portfolio.

Given the global nature of its business, the Company has both domestic and international investments. Credit ratings and pricing of the Company's investments can be negatively affected by liquidity, credit deterioration, financial results, economic risk, political risk, sovereign risk or other factors. As a result, the value and liquidity of the Company's cash, cash equivalents and marketable securities may fluctuate substantially. Therefore, although the Company has not realized any significant losses on its cash, cash equivalents and marketable securities, future fluctuations in their value could result in a significant realized loss.

The Company is exposed to credit risk on its trade accounts receivable, vendor non-trade receivables and prepayments related to long-term supply agreements, and this risk is heightened during periods when economic conditions worsen.
The Company distributes its products through third-party cellular network carriers, wholesalers, retailers and value-added resellers. The Company also sells its products directly to small and mid-sized businesses and education, enterprise and government customers. A substantial majority of the Company's outstanding trade receivables are not covered by collateral, third-party financing arrangements or credit insurance. The Company's exposure to credit and collectability risk on its trade receivables is higher in certain international markets and its ability to mitigate such risks may be limited. The Company also has unsecured vendor non-trade receivables resulting from purchases of components by outsourcing partners and other vendors that manufacture sub-assemblies or assemble final products for the Company. In addition, the Company has made prepayments associated with long-term supply agreements to secure supply of inventory components. As of April 1, 2017, a significant portion of the Company's trade receivables was concentrated within cellular network carriers, and its vendor non-trade receivables and prepayments related to long-term supply agreements were concentrated among a few individual vendors located primarily in Asia. While the Company has procedures to monitor and limit exposure to credit risk on its trade and vendor non-trade receivables, as well as long-term prepayments, there can be no assurance such procedures will effectively limit its credit risk and avoid losses.
The Company could be subject to changes in its tax rates, the adoption of new U.S. or international tax legislation or exposure to additional tax liabilities.
The Company is subject to taxes in the U.S. and numerous foreign jurisdictions, including Ireland, where a number of the Company's subsidiaries are organized. Due to economic and political conditions, tax rates in various jurisdictions may be subject to significant change. The Company's effective tax rates could be affected by changes in the mix of earnings in countries with differing statutory tax rates, changes in the valuation of deferred tax assets and liabilities, or changes in tax laws or their interpretation, including in the U.S. and Ireland.
The Company is also subject to the examination of its tax returns and other tax matters by the U.S. Internal Revenue Service and other tax authorities and governmental bodies. The Company regularly assesses the likelihood of an adverse outcome resulting from these examinations to determine the adequacy of its provision for taxes. There can be no assurance as to the outcome of these examinations. If the Company's effective tax rates were to increase, particularly in the U.S. or Ireland, or if the ultimate determination of the Company's taxes owed is for an amount in excess of amounts previously accrued, the Company's financial condition, operating results and cash flows could be adversely affected.

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

Purchases of Equity Securities by the Issuer and Affiliated Purchasers

Share repurchase activity during the three months ended April 1, 2017 was as follows (in millions, except number of shares, which are reflected in thousands, and per share amounts):

Periods	Total Number of Shares Purchased		Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs		Approximate Dollar Value of Shares That May Yet Be Purchased Under the Plans or Programs [1]
January 1, 2017 to February 4, 2017:						
Open market and privately negotiated purchases	14,505		$119.74	14,505		
February 5, 2017 to March 4, 2017:						
November 2016 ASR	6,343		(2)	6,343		
February 2017 ASR	17,527	(3)	(3)	17,527	(3)	
Open market and privately negotiated purchases	10,386		$134.19	10,386		
March 5, 2017 to April 1, 2017:						
Open market and privately negotiated purchases	6,179		$140.72	6,179		
Total	54,940					$ 24,023

(1) As of April 1, 2017, the Company had an authorized share repurchase program of $175 billion of the Company’s common stock, of which $151 billion had been utilized. The remaining $24 billion in the table represents the amount available to repurchase shares under the authorized repurchase program as of April 1, 2017. The Company’s share repurchase program does not obligate it to acquire any specific number of shares. Under the program, shares may be repurchased in privately negotiated and/or open market transactions, including under plans complying with Rule 10b5-1 under the Exchange Act.

(2) In November 2016, the Company entered into an accelerated share repurchase arrangement (“ASR”) to purchase up to $6.0 billion of the Company's common stock. In February 2017, the purchase period for this ASR ended and an additional 6.3 million shares were delivered and retired. In total, 51.2 million shares were delivered under this ASR at an average repurchase price of $117.29.

(3) In February 2017, the Company entered into a new ASR to purchase up to $3.0 billion of the Company’s common stock. In exchange for an up-front payment of $3.0 billion, the financial institution party to the arrangement committed to deliver shares to the Company during the ASR’s purchase period, which will end in May 2017. The total number of shares ultimately delivered, and therefore the average price paid per share, will be determined at the end of the applicable purchase period based on the volume-weighted average price of the Company’s common stock during that period.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

None.

Item 6. Exhibits
Exhibit Index

Exhibit Number	Exhibit Description	Incorporated by Reference		
		Form	Exhibit	Filing Date/ Period End Date
4.1	Officer's Certificate of the Registrant, dated as of February 9, 2017, including forms of global notes representing the Floating Rate Notes due 2019, Floating Rate Notes due 2020, Floating Rate Notes due 2022, 1.550% Notes due 2019, 1.900% Notes due 2020, 2.500% Notes due 2022, 3.000% Notes due 2024, 3.350% Notes due 2027 and 4.250% Notes due 2047.	8-K	4.1	2/9/17
4.2	Officer's Certificate of the Registrant, dated as of March 3, 2017, including form of global note representing 4.300% Notes due 2047.	8-K	4.1	3/3/17
31.1*	Rule 13a-14(a) / 15d-14(a) Certification of Chief Executive Officer.			
31.2*	Rule 13a-14(a) / 15d-14(a) Certification of Chief Financial Officer.			
32.1**	Section 1350 Certifications of Chief Executive Officer and Chief Financial Officer.			
101.INS*	XBRL Instance Document.			
101.SCH*	XBRL Taxonomy Extension Schema Document.			
101.CAL*	XBRL Taxonomy Extension Calculation Linkbase Document.			
101.DEF*	XBRL Taxonomy Extension Definition Linkbase Document.			
101.LAB*	XBRL Taxonomy Extension Label Linkbase Document.			
101.PRE*	XBRL Taxonomy Extension Presentation Linkbase Document.			

* Filed herewith.
** Furnished herewith.

SIGNATURE

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

May 3, 2017 Apple Inc.

By: /s/ Luca Maestri
Luca Maestri
Senior Vice President,
Chief Financial Officer

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