COGENT COMMUNICATIONS GROUP INC
Form 10-K
March 14, 2007

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K

(Mark One)

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

For the fiscal year ended December 31, 2006

OR

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

For the transition period from to

Commission file number 1-31227

COGENT COMMUNICATIONS GROUP, INC.

(Exact Name of Registrant as Specified in Its Charter)

Delaware (State or Other Jurisdiction of Incorporation or Organization)	**52-2337274** (I.R.S. Employer Identification No.)
1015 31st Street N.W. **Washington, D.C.** (Address of Principal Executive Offices)	**20007** (Zip Code)

(202) 295-4200

Registrant s Telephone Number, Including Area Code

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

Common Stock, par value $0.001 per share

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

None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes x No o

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. Yes o No x

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. x

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

Large accelerated filer o Accelerated filer x Non-accelerated filer o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No x

The number of shares outstanding of the issuer s common stock, par value $0.001 per share, as of March 1, 2007 was 49,005,223.

The aggregate market value of the Common Stock held by non-affiliates of the registrant, based on the closing price of $9.37 per share on June 30, 2006 as reported by the NASDAQ National Market was approximately $263.6 million.

COGENT COMMUNICATIONS GROUP, INC.
FORM 10-K ANNUAL REPORT

FOR THE YEAR ENDED DECEMBER 31, 2006

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DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant s definitive proxy statement for the registrant s 2007 annual shareholders meeting are incorporated by reference in Part III of this Form 10-K.

SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This report may contain forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended. Forward-looking statements are not statements of historical facts, but rather reflect our current expectations concerning future results and events. You can identify these forward-looking statements by our use of words such as anticipates, believes, continues, expects, intends, likely, opportunity, plans, potential, project, will, and similar expressions to identify forward-looking statements, whether in the negative or the affirmative. We cannot guarantee that we actually will achieve these plans, intentions or expectations. These forward-looking statements are subject to risks, uncertainties and other factors, some of which are beyond our control, which could cause actual results to differ materially from those forecast or anticipated in such forward-looking statements.

You should not place undue reliance on these forward-looking statements, which reflect our view only as of the date of this report. We undertake no obligation to update these statements or publicly release the result of any revisions to these statements to reflect events or circumstances after the date of this report or to reflect the occurrence of unanticipated events.

PART I

ITEM 1. BUSINESS

Overview

We are a leading facilities-based provider of low-cost, high-speed Internet access and Internet Protocol, or IP, communications services. Our network is specifically designed and optimized to transmit data using IP. We deliver our services to small and medium-sized businesses, communications service providers and other bandwidth-intensive organizations through approximately 12,300 customer connections in North America and Europe.

Our primary on-net service is Internet access at a speed of 100 Megabits per second, much faster than typical Internet access currently offered to businesses. We offer this on-net service exclusively through our own facilities, which run all the way to our customers premises. Because of our integrated network architecture, we are not dependent on local telephone companies to serve our on-net customers. Our typical customers in multi-tenant office buildings are law firms, financial services firms, advertising and marketing firms and other professional services businesses. We also provide on-net Internet access to certain bandwidth-intensive users such as universities, other ISPs and commercial content providers at speeds of up to ten Gigabits per second. For the years ended December 31, 2006, 2005 and 2004 our on-net customers generated 70.6%, 57.9% and 63.5%, respectively, of our total net service revenue.

In addition to providing our on-net services, we also provide Internet connectivity to customers that are not located in buildings directly connected to our network. We serve these off-net customers using other carriers facilities to provide the last mile portion of the link from our customers premises to our network. For the years ended December 31, 2006, 2005 and 2004, our off-net customers generated 23.1%, 33.0%, and 24.4%, respectively, of our total net service revenue.

Non-core services are those services we acquired and continue to support but do not actively sell. For the years ended December 31, 2006, 2005 and 2004, non-core services generated 6.3% and 9.1% and 12.1%, respectively, of our total net service revenue.

We also operate 28 data centers comprising over 250,000 square feet throughout North America and Europe that allow customers to co-locate their equipment and access our network.

Competitive Advantages

We believe we address many of the IP data communications needs of small and medium-sized businesses, communications service providers and other bandwidth-intensive organizations by offering them high-quality Internet service at attractive prices.

Low Cost of Operation. We offer a streamlined set of products on an integrated network that operates on a single protocol. Our network design allows us to avoid many of the costs associated with circuit-switched networks related to provisioning, monitoring and maintaining multiple transport protocols. Our low cost of operation gives us greater pricing flexibility and an advantage in a competitive environment characterized by falling Internet access prices.

Independent Network. Our on-net service does not rely on infrastructure controlled by local incumbent telephone companies. We provide the entire network, including the last mile and the in-building wiring to the customer s suite. This gives us more control over our service, quality and pricing and allows us to provision services more quickly and efficiently. We are typically able to activate customer services in one of our on-net buildings in fewer than twelve days.

High Quality, Reliable Service. We are able to offer high-quality Internet service due to our network, which was designed solely to transmit IP data, and dedicated intra-city bandwidth for each customer. This

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design increases the speed and throughput of our network and reduces the number of data packets dropped during transmission.

Low Capital Cost to Grow Our Business. We have incurred relatively minimal indebtedness in growing our business because of our network design of using Internet routers without additional legacy equipment and our strategy of acquiring optical fiber from the excess capacity in existing networks.

Experienced Management Team. Our senior management team is composed of seasoned executives with extensive expertise in the telecommunications industry as well as knowledge of the markets in which we operate. The members of our senior management team have an average of 20 years of experience in the telecommunications industry. Our senior management team has designed and built our network and led the integration of our network assets, customers and service offerings we acquired through 13 acquisitions.

Convergence. There is a clear industry and market trend for legacy products (e.g., TDM voice, Private Line, Frame Relay, and Asynchronous Transfer Mode) to converge on IP. Many of our competitors will have to migrate their existing customers and products to IP. This migration can be costly, lengthy, and risky. We do not face this challenge because our network and products are IP.

Our Strategy

We intend to become the leading provider of high quality Internet access and IP communications services and to continue to improve our profitability and cash flow. The principal elements of our strategy include:

Focus on Providing Low-Cost, High-Speed Internet Access and IP Connectivity. We intend to further load our high-capacity network to respond to the growing demand for high-speed Internet service generated by bandwidth-intensive applications such as streaming media, online gaming, voice over IP (VOIP), remote data storage, distributed computing and virtual private networks. We intend to do so by continuing to offer our high-speed and high capacity services at competitive prices.

Pursuing On-Net Customer Growth. We intend to increase usage of our network and operational infrastructure by adding customers in our existing on-net buildings, as well as adding buildings to our network.

Selectively Pursuing Acquisition Opportunities. In addition to adding customers through our sales and marketing efforts, we will continue to seek out acquisition opportunities that increase our customer base, allowing us to take advantage of the unused capacity of our network and add revenues with minimal incremental costs. We may also make additional acquisitions to add network assets at attractive prices.

Our Network

Our network is comprised of in-building riser facilities, metropolitan optical networks, metropolitan traffic aggregation points and inter-city transport facilities. We deliver a high level of technical performance because our network is optimized for IP traffic. Our network is more reliable and delivers IP traffic at lower cost than networks built as overlays to traditional circuit-switched telephone networks.

Our network serves 90 metropolitan markets in North America and Europe and encompasses:

- over 850 multi-tenant office buildings strategically located in commercial business districts;
- over 240 carrier-neutral Internet aggregation facilities, data centers and single-tenant buildings;
- over 200 intra-city networks consisting of over 9,800 fiber miles;

- an inter-city network of more than 23,000 fiber route miles; and
- multiple leased high-capacity transatlantic circuits connecting the North American and European portions of our network.

We have created our network by acquiring optical fiber from carriers with large amounts of unused fiber and directly connecting Internet routers to the existing optical fiber national backbone. We have expanded our network through key acquisitions of financially distressed companies or their assets at a significant discount to their original cost. Due to our network design and acquisition strategy, we believe we are positioned to grow our revenue and increase profitability with limited incremental capital expenditures. We expect our 2007 capital expenditure rate to be similar to the rate we experienced in 2006.

Inter-city Networks

Our inter-city network consists of optical fiber connecting major cities in North America and Europe. The North American and European portions of our network are connected by transatlantic circuits. Our network was built by acquiring from various owners of fiber optic networks the right to use one or two strands of optical fiber out of the multiple fibers owned by the carrier. We have installed the optical and electronic equipment necessary to amplify, regenerate, and route the optical signals along these networks. We have the right to use the fiber under long term agreements. We pay these providers fees for the maintenance of the optical fiber and provide our own equipment maintenance. The larger providers of our inter-city optical fiber are WilTel (now part of Level 3) in the United States, LDCOM (now part of Neuf Cegetel in France, MTI in Germany, Telia Sonera in Europe, and RENFE (adif) in Spain.

Intra-city Networks

In each metropolitan area in which we provide high-speed on-net Internet access service, our backbone network is connected to a router connected to one or more of our metropolitan optical networks. We create our intra-city networks by obtaining the right to use optical fiber from carriers with large amounts of unused capacity. These metropolitan networks consist of optical fiber that runs from the central router in a market into routers located in on-net buildings. In most cases the metropolitan fiber runs in a ring architecture, which provides redundancy so that if the fiber is cut, data can still be transmitted to the central router by directing traffic in the opposite direction around the ring. The router in the building provides a connection to each on-net customer.

Within the cities where we offer off-net Internet access service, we lease circuits from telecommunications carriers, primarily local telephone companies, to provide the last mile connection to the customer s premises. Typically, these circuits are aggregated at various locations in those cities onto higher-capacity leased circuits that ultimately connect the local aggregation route to our network.

In-Building Networks

In office buildings where we provide service to multiple tenants we connect our routers to a cable containing 12 to 288 optical fiber strands that typically run from our equipment in the basement of the building through the building riser to the customer location. Service for customers is initiated by connecting a fiber optic cable from a customer s local area network to the infrastructure in the building riser. The customer then has dedicated and secure access to our network using an Ethernet connection. Ethernet is the lowest cost network connection technology and is used almost universally for the local area networks that businesses operate.

Internetworking

The Internet is an aggregation of interconnected networks. We interconnect our network with most major and hundreds of minor Internet Service Providers, or ISPs, at approximately 70 locations. We interconnect our network through public and private peering arrangements. Public peering is the means by which ISPs have traditionally connected to each other at central, public facilities. Larger ISPs also

exchange traffic and interconnect their networks by means of direct private connections referred to as private peering.

Peering agreements between ISPs are necessary in order for them to exchange traffic. Without peering agreements, each ISP would have to buy Internet access from every other ISP in order for its customer s traffic, such as email, to reach and be received from customers of other ISPs. We are considered a Tier 1 ISP and, as a result, have settlement-free peering arrangements with most other providers. This allows us to exchange traffic with those ISPs without payment by either party. In such arrangements, each party exchanging traffic bears its own cost of delivering traffic to the point at which it is handed off to the other party. We also engage in public peering arrangements in which each party also pays a fee to the owner of routing equipment that operates as the central exchange for all the participants. We do not treat our settlement-free peering arrangements as generating revenue or expense related to the traffic exchanged. Where we do not have settlement-free peering connection with an ISP, we exchange traffic through an intermediary, whereby such intermediary receives payment from us. Approximately 3% of our traffic is handled this way.

Network Management and Control

Our primary network operations centers are located in Washington, D.C and Madrid, Spain. These facilities provide continuous operational support in both North America and Europe. Our network operations centers are designed to immediately respond to any problems in our network. To ensure the quick replacement of faulty equipment in the intra-city and long-haul networks, we have deployed field engineers across North America and Europe. In addition, we have maintenance contracts with third party vendors that specialize in optical and routed networks.

Our Services

We offer high-speed Internet access and IP connectivity to small and medium-sized businesses, communications providers and other bandwidth-intensive organizations located in North America and Europe.

The table below shows our primary service offerings:

On-Net Services	**Bandwidth (Mbps)**
Fiber500	0.5
Two Meg	2.0
Fast Ethernet	100
Gigabit Ethernet	1,000
10 Gigabit Ethernet	10,000
Colocation with Internet Access	2 to 10,000
Point-to-Point	1.5 to 10,000
Off-Net Services	
T1 or E1	1.5 or 2.0
T3 or E3	45 or 34
Ethernet	10, 100 or 1,000

We offer on-net services in 79 metropolitan markets. We serve over 1,100 buildings of which more than 960 are located in North America with the remainder located in Europe. Our most popular on-net service in North America is our Fast Ethernet service, which provides Internet access at 100 megabits per second. We typically offer our Fast Ethernet (Internet access) service to our small and medium-sized business customers at $1,000 a month for month-to-month service. We offer lower prices for longer term

commitments typically $900 per month for a one year term and $800 per month for a two year term. We also offer Internet access services at higher speeds of up to ten Gigabits per second. These services are generally used by customers that have businesses, such as web hosting, that are Internet based and are generally delivered at data centers and carrier hotels. We believe that, on a per-Megabit basis, this service offering is one of the lowest priced in the marketplace. We also offer colocation services in 28 locations in North America and Europe. This service offers Internet access combined with rack space and power in a Cogent facility, allowing the customer to locate a server or other equipment at that location and connect to our Internet service. Our final on-net service offering is our Point-to-Point or Layer 2 service. These point-to-point connections span North America and Europe and allow customers to connect geographically dispersed local area networks in a seamless manner. We emphasize the sale of on-net services because we believe that we have a competitive advantage in providing these services and our sales of these services generate higher gross profit margins.

We offer off-net services to customers not located in our on-net buildings. These services are provided in the metropolitan markets in North America and Europe in which we offer on-net services and in approximately 10 additional markets. These services are generally provided to small and medium-sized businesses. A significant amount of our off-net revenues were acquired revenues, which have historically churned at a greater rate than our on-net revenues. As a result, we expect the revenue from these off-net services to continue to decline. We expect the growth of our on-net Internet services to compensate for this loss.

We support a number of non-core services assumed with certain of our acquisitions. These services include our managed modem service, email service, dial-up Internet, shared web hosting and voice services in Toronto, Canada, managed web hosting, managed security and legacy point-to-point services. Our managed modem service is offered to larger businesses and other Internet service providers that serve individuals that dial in to the Internet. The business or ISP is our customer for this service. Individuals make use of the dial-in access through arrangements with the business or ISP. We expect the revenue from these non-core services to decline. We expect the growth of our on-net Internet services to compensate for this loss.

Sales and Marketing

Sales. We employ a relationship-based sales and marketing approach. As of March 1, 2007, our sales force included 143 full-time employees focused solely on acquiring and retaining customers. Our outside direct sales personnel work through direct face-to-face contact with potential customers in, or intending to locate in, on-net buildings. Through agreements with building owners, we are able to initiate and maintain personal contact with our customers by staging various promotional and social events in our on-net buildings. Direct sales personnel are compensated with a base salary plus quota-based commissions and incentives. We use a customer relationship management system to efficiently track activity levels and sales productivity.

Agent Program. We also have an agent program used as an alternate channel to distribute our products and services. The agent program consists of value-added resellers, IT consultants, and smaller telecom agents, who are managed by our direct sales personnel, and larger national or regional companies whose primary business is to sell telecommunications, data, and Internet services. The agent program includes over 110 agents.

Marketing. Because of our focus on a direct sales force, we have not spent funds on television, radio or print advertising. Our marketing efforts are designed to drive awareness of our products and services, identify qualified leads through various direct marketing campaigns and provide our sales force with product brochures, collateral materials and relevant sales tools to improve the overall effectiveness of our sales organization. In addition, we conduct public relations efforts focused on cultivating industry analyst

and media relationships with the goal of securing media coverage and public recognition of our Internet communications services. Our marketing organization is responsible for our product strategy and direction based upon primary and secondary market research and the advancement of new technologies.

Competition

We face competition from incumbent carriers, Internet service providers and facilities-based network operators, many of whom are much bigger than us, have significantly greater financial resources, better-established brand names and large, existing installed customer bases in the markets in which we compete. We also face competition from other new entrants to the communications services market. Many of these companies offer products and services that are similar to our products and services, and we expect the level of competition to intensify in the future. Unlike some of our competitors, we do not have title to most of the dark fiber that makes up our network. Our interests in that dark fiber are in the form of long-term leases or IRUs obtained from their titleholders. We rely on the maintenance of such dark fiber to provide our on-net services to customers. We are also dependent on third-party providers, some of whom are our competitors, for the provision of lines to our off-net customers.

We believe that competition is based on many factors, including price, transmission speed, ease of access and use, breadth of service availability, reliability of service, customer support and brand recognition. Because our fiber optic networks have been recently installed compared to those of the incumbent carriers, our state-of-the-art technology may provide us with cost, capacity, and service quality advantages over some existing incumbent carrier networks; however, our network may not support some of the services supported by these legacy networks, such as circuit-switched voice and frame relay. While the Internet access speeds offered by traditional ISPs typically do not match our on-net offerings, these slower services are usually priced lower than our offerings and thus provide competitive pressure on pricing, particularly for more price-sensitive customers. Additionally, some of our competitors have recently emerged from bankruptcy. Because the bankruptcy process allows for the discharge of debts and rejection of certain obligations, we may have less of an advantage with respect to these competitors. These and other downward pricing pressures have diminished, and may further diminish, the competitive advantages that we have enjoyed as the result of our service pricing.

Regulation

In the United States, the Federal Communications Commission (FCC) regulates common carriers interstate services and state public utilities commissions exercise jurisdiction over intrastate basic telecommunications services. Our Internet service offerings are not currently regulated by the FCC or any state public utility commission. However, as we expand our offerings we may become subject to regulation in the U.S. at the federal and state levels and in other countries. The offerings of many of our competitors and vendors, especially incumbent local telephone companies, are subject to direct federal and state regulations. These regulations change from time to time in ways that are difficult for us to predict.

In the United States, we are subject to the obligations set forth in the Communications Assistance for Law Enforcement Act, which is administered by the FCC. That law requires that we be able to intercept communications when required to do so by law enforcement agencies. We are required to comply or we may face significant fines and penalties.

There is no current legal requirement that owners or managers of commercial office buildings give access to competitive providers of telecommunications services, although the FCC does prohibit carriers from entering contracts that restrict the right of commercial multiunit property owners to permit any other common carrier to access and serve the property s commercial tenants.

Our subsidiary, Cogent Canada, offers voice and Internet services in Canada. Generally, the regulation of Internet access services and competitive voice services has been similar in Canada to that in

the U.S. in that providers of such services face fewer regulatory requirements than the incumbent local telephone company. This may change. Also, the Canadian government has requirements limiting foreign ownership of certain telecommunications facilities in Canada. We are not subject to these restrictions today. We will have to comply with these regulations to the extent they change and to the extent we begin using facilities in a manner that subjects us to these restrictions.

Our European subsidiaries operate in a more highly regulated environment for the types of services they provide. In many Western European countries, a national license or a notice filed with a regulatory authority is required for the provision of data and Internet services. In addition, our subsidiaries operating in member countries of the European Union are subject to the directives and jurisdiction of the European Union. We believe that each of our subsidiaries has the necessary licenses to provide its services in the markets where it operates today. To the extent we expand our operations or service offerings in Europe or other new markets, we may face new regulatory requirements.

The laws related to Internet telecommunications are unsettled and there may be new legislation and court decisions that may affect our services and expose us to liability.

Employees

As of March 1, 2007, we had 377 employees. A union represents twenty-two of our employees in France. We believe that we have a satisfactory relationship with our employees.

Available Information

We make available free of charge through our Internet website our annual report on Form 10-K, our quarterly reports on Form 10-Q, our current reports on Form 8-K, and any amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act. The reports are made available through a link to the SEC s Internet website at *www.sec.gov* . You can find these reports and request a copy of our Code of Conduct on our website at *www.cogentco.com* under the Investor Relations link.

ITEM 1A. RISK FACTORS

If our operations do not consistently produce positive cash flow to pay for our growth or meet our operating and financing obligations, and we are unable to otherwise raise additional capital to meet these needs, our ability to implement our business plan will be materially and adversely affected.

Until we can consistently generate positive cash flow from our operations, we will continue to rely on our cash reserves and, potentially, additional equity and debt financings to meet our cash needs. Our future capital requirements likely will increase if we acquire or invest in additional businesses, assets, services or technologies. We may also face unforeseen capital requirements for new technology required to remain competitive or to comply with new regulatory requirements, for unforeseen maintenance of our network and facilities, and for other unanticipated expenses associated with running our business. In addition, if we do not retain existing customers or add new customers, we may be required to raise additional funds through the issuance of debt or equity. We cannot assure you that we will have access to necessary capital, nor can we assure you that any such financing will be available on terms that are acceptable to our stockholders or us. If issuing equity securities raises additional funds, substantial dilution to existing stockholders may result.

We need to retain existing customers and continue to add new customers in order to become profitable and remain cash flow positive.

In order to become profitable and remain consistently cash flow positive, we need to both retain existing customers and continue to add a large number of new customers. The precise number of additional customers required to become profitable and remain consistently cash flow positive is dependent on a number of factors, including the turnover of existing customers and the revenue mix among customers. We may not succeed in adding customers if our sales and marketing plan is unsuccessful. In addition, many of our target customers are existing businesses that are already purchasing Internet access services from one or more providers, often under a contractual commitment, and it has been our experience that such target customers are often reluctant to switch providers due to costs associated with switching providers. Further, as some of our customers grow larger they may decide to build their own Internet networks. While no single customer accounted for more than 1.7% of our 2006 revenues, a migration of a few very large Internet users to their own networks could impair our growth.

We have historically incurred operating losses and these losses may continue for the foreseeable future.

Since we initiated operations in 2000, we have generated operating losses and these losses may continue for the foreseeable future. In 2004 we had an operating loss of $84.1 million, in 2005 we had an operating loss of $62.1 million and in 2006 we had an operating loss of $46.6 million. As of December 31, 2006, we had an accumulated deficit of $265.0 million. Continued losses may prevent us from pursuing our strategies for growth or may require us to seek unplanned additional capital and could cause us to be unable to meet our debt service obligations, capital expenditure requirements or working capital needs.

We are experiencing rapid growth of our business and operations and we may not be able to efficiently manage our growth.

We have rapidly grown our company through acquisitions of companies, assets and customers as well as implementation of our own network expansion and the acquisition of new customers through our own sales efforts. Our expansion places significant strains on our management, operational and financial infrastructure. Our ability to manage our growth will be particularly dependent upon our ability to:

- expand, develop and retain an effective sales force and qualified personnel;
- maintain the quality of our operations and our service offerings;

- maintain and enhance our system of internal controls to ensure timely and accurate compliance with our regulatory reporting requirements; and

- expand our accounting and operational information systems in order to support our growth.

If we fail to implement these measures successfully, our ability to manage our growth will be impaired.

We may experience difficulties in implementing our business plan in Europe and may incur related unexpected costs.

During the first quarter of 2004, we began operations in Europe through our acquisition of Firstmark, the parent holding company of LambdaNet Communications France SAS, or LambdaNet France, and LambdaNet Communications Espana SA, or LambdaNet Spain, and have obtained the rights to certain dark fiber and other network assets that were once part of Carrier 1 International S.A. in Germany. Prior to these transactions, we had only minimal European operations. We are expanding our operations in Europe. If we are not successful in developing our market presence in Europe, our operating results could be adversely affected.

We may experience delays and additional costs in expanding our on-net buildings.

Currently, we plan to increase our carrier-neutral facilities and other on-net buildings from 1,107 at December 31, 2006 to approximately 1,160 at December 31, 2007. We may be unsuccessful at identifying appropriate buildings or negotiating favorable terms for acquiring access to such buildings, and consequently, may experience difficulty in adding customers to our network and fully using the network s capacity.

We may not successfully make or integrate acquisitions or enter into strategic alliances.

As part of our growth strategy, we intend to pursue selected acquisitions and strategic alliances. To date, we have completed 13 acquisitions. We compete with other companies for acquisition opportunities and we cannot assure you that we will be able to effect future acquisitions or strategic alliances on commercially reasonable terms or at all. Even if we enter into these transactions, we may experience:

- delays in realizing or a failure to realize the benefits we anticipate;

- difficulties or higher-than-anticipated costs associated with integrating any acquired companies, products or services into our existing business;

- attrition of key personnel from acquired businesses;

- unexpected costs or charges; or

- unforeseen operating difficulties that require significant financial and managerial resources that would otherwise be available for the ongoing development or expansion of our existing operations.

In the past, our acquisitions have often included assets, service offerings and financial obligations that are not compatible with our core business strategy. We have expended management attention and other resources to the divestiture of assets, modification of products and systems as well as restructuring financial obligations of acquired operations. In most acquisitions, we have been successful in renegotiating long-term agreements that we have acquired relating to long distance and local transport of data and IP traffic. If we are unable to satisfactorily renegotiate such agreements in the future or with respect to future acquisitions, we may be exposed to large claims for payment for services and facilities we do not need.

Consummating these transactions could also result in the incurrence of additional debt and related interest expense, as well as unforeseen contingent liabilities, all of which could have a material adverse effect on our business, financial condition and results of operations. Because we have purchased financially

distressed companies or their assets, and may continue to do so in the future, we have not had, and may not have, the opportunity to perform extensive due diligence or obtain contractual protections and indemnifications that are customarily provided in corporate acquisitions. As a result, we may face unexpected contingent liabilities arising from these acquisitions. We may also issue additional equity in connection with these transactions, which would dilute our existing shareholders.

Revenues generated by the customer contracts that we have acquired have accounted for a substantial portion of our historical growth in net service revenue. However, following an acquisition, we have experienced a decline in revenue attributable to acquired customers as these customers contracts have expired and they have entered into standard Cogent customer contracts at generally lower rates or have chosen not to renew service with us. We anticipate that we will experience similar declines with respect to customers we have acquired or will acquire.

We depend upon our key employees and may be unable to attract or retain sufficient qualified personnel.

Our future performance depends upon the continued contribution of our executive management team and other key employees.

Our connections to the Internet require us to establish and maintain relationships with other providers, which we may not be able to maintain.

The Internet is composed of various public and private network providers who operate their own networks and interconnect them at public and private interconnection points. Our network is one such network. In order to obtain Internet connectivity for our network, we must establish and maintain relationships with other providers and incur the necessary capital costs to locate our equipment and connect our network at these various interconnection points.

By entering into what are known as settlement-free peering arrangements, providers agree to exchange traffic between their respective networks without charging each other. Our ability to avoid the higher costs of acquiring dedicated network capacity and to maintain high network performance is dependent upon our ability to establish and maintain peering relationships. The terms and conditions of our peering relationships may also be subject to adverse changes, which we may not be able to control. For example, several network operators with large numbers of individual users are arguing that they should be able to charge or charge more to network operators and businesses that send traffic to those users. If we are not able to maintain or increase our peering relationships in all of our markets on favorable terms, we may not be able to provide our customers with high performance or affordable services, which could have a material adverse effect on our business. We have in the past encountered some disputes with certain of our providers regarding our peering arrangements, but we have generally been able to route our traffic through alternative peering arrangements, resolve such disputes, or terminate such peering arrangements with a minimal adverse impact on our business. In the past we had two such disputes that resulted in a temporary disruption of the exchange of traffic between our network and the network of the other carrier. We continue to experience resistance from certain incumbent telephone companies, especially in Europe, to the upgrade of settlement free peering connections necessary to accommodate the growth of traffic we send to such carriers. We cannot assure you that we will be able to continue to establish and maintain relationships with providers or favorably resolve disputes with providers.

We make some of our connections to other Internet networks pursuant to agreements through carriers that make data transmission capacity available to us at negotiated rates. In some instances these agreements have minimum and maximum volume commitments. If we fail to meet the minimum, or exceed the maximum, volume commitments, our costs may rise.

Our operations outside of the United States expose us to economic, regulatory and other risks.

The nature of our European and Canadian business involves a number of risks, including:

- fluctuations in currency exchange rates;
- exposure to additional regulatory requirements, including import restrictions and controls, exchange controls, tariffs and other trade barriers;
- difficulties in staffing and managing our foreign operations;
- changes in political and economic conditions; and
- exposure to additional and potentially adverse tax regimes.

As we continue to expand our European and Canadian business, our success will depend, in part, on our ability to anticipate and effectively manage these and other risks. Our failure to manage these risks and grow our European and Canadian operations may have a material adverse effect on our business and results of operations.

Fluctuations in foreign exchange rates may adversely affect our financial position and results of operations.

Our European and Canadian operations expose us to currency fluctuations and exchange rate risk. For example, while we record revenues and financial results from our European operations in euros, these results are reflected in our consolidated financial statements in U.S. dollars. Therefore, our reported results are exposed to fluctuations in the exchange rates between the U.S. dollar and the euro. In particular, we fund the euro-based operating expenses and associated cash flow requirements of our European operations, including IRU obligations, in U.S. dollars. Accordingly, in the event that the euro strengthens versus the dollar to a greater extent than we anticipate, the expenses and cash flow requirements associated with our European operations may be significantly higher in U.S.-dollar terms than planned.

Our business could suffer delays and problems due to the actions of network providers on whom we are partially dependent.

Our off-net customers are connected to our network by means of communications lines that are provided as services by local telephone companies and others. We may experience problems with the installation, maintenance and pricing of these lines and other communications links, which could adversely affect our results of operations and our plans to add additional customers to our network using such services. We have historically experienced installation and maintenance delays when the network provider is devoting resources to other services, such as traditional telephony. We have also experienced pricing problems when a lack of alternatives allows a provider to charge high prices for services in an area. We attempt to reduce this problem by using many different providers so that we have alternatives for linking a customer to our network. Competition among the providers tends to improve installation, maintenance and pricing.

If the information systems that we depend on to support our customers, network operations, sales and billing do not perform as expected, our operations and our financial results may be adversely affected.

We rely on complex information systems to operate our network and support our other business functions. Our ability to track sales leads, close sales opportunities, provision services and bill our customers for those services depends upon the effective integration of our various information systems. If our systems, individually or collectively, fail or do not perform as expected, our ability to process and provision orders, to make timely payments to vendors and to ensure that we collect revenue owed to us would be adversely affected. Such failures or delays could result in increased capital expenditures,

customer and vendor dissatisfaction, loss of business or the inability to add new customers or additional services, all of which would adversely affect our business and results of operations.

We may have difficulty implementing the ability to intercept communications as required by the U. S. Communications Assistance for Law Enforcement Act.

In 2006, we began the process of implementing the requirements of the U. S. Communications Assistance for Law Enforcement Act. This law requires that we able to intercept communications when required to do so by law enforcement agencies. We may experience difficulties and significant costs in implementing the operations procedures and installing the equipment and software necessary to comply with the law. If we are unable to comply with the laws we could be subject to fines of up to $1 million per event and other penalties.

Our business could suffer from an interruption of service from our fiber providers.

The carriers from whom we have obtained our inter-city and intra-city dark fiber maintain that fiber. If these carriers fail to maintain the fiber or disrupt our fiber connections for other reasons, such as business disputes with us and governmental takings, our ability to provide service in the affected markets or parts of markets would be impaired. The companies that maintain our inter-city dark fiber and many of the companies that maintain our intra-city dark fiber are also competitors of ours. Consequently, they may have incentives to act in ways unfavorable to us. While we have successfully mitigated the effects of prior service interruptions and business disputes in the past, we may incur significant delays and costs in restoring service to our customers in connection with future service interruptions, and we may lose customers if delays are substantial.

Our business depends on agreements with colocation operators, which we could fail to obtain or maintain.

Our business depends upon access to customers in carrier neutral colocation centers, which are facilities in which many large users of the Internet house the computer servers that deliver content and applications to users by means of the Internet and provide access to multiple Internet access networks. Most colocation centers with which we deal allow any carrier to operate within the facility (for a standard fee). We expect to enter into additional colocation agreements as part of our growth plan. Current government regulations do not require colocation operators to allow all carriers access on terms that are reasonable or nondiscriminatory. We have been successful in obtaining agreements with these operators in the past and have generally found that the operators want to have us in their colocation facilities because we offer low-cost, high capacity Internet service to their other customers. Any deterioration in our existing relationships with these colocation center operators could harm our marketing efforts and could substantially reduce our potential customer base.

Our business depends on license agreements with building owners and managers, which we could fail to obtain or maintain.

Our business depends upon our in-building networks. Our in-building networks depend on access agreements with building owners or managers allowing us to install our in-building networks and provide our services in the buildings. These agreements typically have terms of five to ten years, with one or more renewal options. Any deterioration in our existing relationships with building owners or managers could harm our marketing efforts and could substantially reduce our potential customer base. We expect to enter into additional access agreements as part of our growth plan. Current federal and state regulations do not require building owners to make space available to us or to do so on terms that are reasonable or nondiscriminatory. While the FCC has adopted regulations that prohibit common carriers under its jurisdiction from entering into exclusive arrangements with owners of multi-tenant commercial office buildings, these regulations do not require building owners to offer us access to their buildings. Building

owners or managers may decide not to permit us to install our networks in their buildings or may elect not to renew or amend our access agreements. The initial term of most of our access agreements will conclude in the next several years. Most of these agreements have one or more automatic renewal periods and others may be renewed at the option of the landlord. While we have historically been successful in renewing these agreements and no single building access agreement is material to our success, the failure to obtain or maintain a number of these agreements would reduce our revenue, and we might not recover our costs of procuring building access and installing our in-building networks.

We may not be able to obtain or construct additional building laterals to connect new buildings to our network.

In order to connect a new building to our network we need to obtain or construct a lateral from our metropolitan network to the building. We may not be able to obtain fiber in an existing lateral at an attractive price from a provider and may not be able to construct our own lateral due to the cost of construction or municipal regulatory restrictions. Failure to obtain fiber in an existing lateral or to construct a new lateral could keep us from adding new buildings to our network and from increasing our revenues.

Impairment of our intellectual property rights and our alleged infringement on other companies intellectual property rights could harm our business.

We are aware of several other companies in our and other industries that use the word Cogent in their corporate names. One company has informed us that it believes our use of the name Cogent infringes on their intellectual property rights in that name. If such a challenge is successful, we could be required to change our name and lose the goodwill associated with the Cogent name in our markets.

The sector in which we operate is highly competitive, and we may not be able to compete effectively.

We face significant competition from incumbent carriers, Internet service providers and facilities-based network operators. Relative to us, many of these providers have significantly greater financial resources, more well-established brand names, larger customer bases, and more diverse strategic plans and service offerings.

Intense competition from these traditional and new communications companies has led to declining prices and margins for many communications services, and we expect this trend to continue as competition intensifies in the future. Decreasing prices for high-speed Internet services have somewhat diminished the competitive advantage that we have enjoyed as a result of our service pricing.

Our competitors may also introduce new technology or services that make our services less attractive to potential customers. For example, some providers are introducing a new version of the Internet protocol (Ipv6) that we do not plan to introduce at this time. If this becomes important to Internet users our ability to compete may be lessened or we may have to incur additional costs in order to accommodate this technology.

We issue projected results and estimates for future periods from time to time, and such projections and estimates are subject to inherent uncertainties and may prove to be inaccurate.

Financial information, results of operations and other projections that we may issue from time to time are based upon our assumptions and estimates. While we believe these assumptions and estimates to be reasonable, they are inherently subject to significant business, economic and competitive uncertainties and contingencies, many of which are beyond our control. You should understand that certain unpredictable factors could cause our actual results to differ from our expectations and those differences may be material. No independent expert participates in the preparation of these estimates. These estimates should not be regarded as a representation by us as to our results of operations during such periods as there can

be no assurance that any of these estimates will be realized. In light of the foregoing, we caution you not to place undue reliance on these estimates. These estimates constitute forward-looking statements.

Network failure or delays and errors in transmissions expose us to potential liability.

Our network uses a collection of communications equipment, software, operating protocols and proprietary applications for the high-speed transportation of large quantities of data among multiple locations. Given the complexity of our network, it is possible that data will be lost or distorted. Delays in data delivery may cause significant losses to one or more customers using our network. Our network may also contain undetected design faults and software bugs that, despite our testing, may not be discovered in time to prevent harm to our network or to the data transmitted over it. The failure of any equipment or facility on the network could result in the interruption of customer service until we effect necessary repairs or install replacement equipment. Network failures, delays and errors could also result from natural disasters, power losses, security breaches, computer viruses, denial of service attacks and other natural or man-made events. Our off-net services are dependent on the network of other providers or on local telephone companies. Network failures, faults or errors could cause delays or service interruptions, expose us to customer liability or require expensive modifications that could have a material adverse effect on our business.

As an Internet access provider, we may incur liability for information disseminated through our network.

The law relating to the liability of Internet access providers and on-line services companies for information carried on or disseminated through their networks is unsettled. As the law in this area develops and as we expand our international operations, the potential imposition of liability upon us for information carried on and disseminated through our network could require us to implement measures to reduce our exposure to such liability, which may require the expenditure of substantial resources or the discontinuation of certain products or service offerings. Any costs that are incurred as a result of such measures or the imposition of liability could harm our business.

Legislation and government regulation could adversely affect us.

As an enhanced service provider, we are not subject to substantial regulation by the FCC or the state public utilities commissions in the United States. Internet service is also subject to minimal regulation in Europe and in Canada. If we decide to offer traditional voice services or otherwise expand our service offerings to include services that would cause us to be deemed a common carrier, we will become subject to additional regulation. Additionally, if we offer voice service using IP (voice over IP) or offer certain other types of data services using IP we may become subject to additional regulation. This regulation could impact our business because of the costs and time required to obtain necessary authorizations, the additional taxes than we may become subject to or may have to collect from our customers, and the additional administrative costs of providing voice services, and other costs. Even if we do not decide to offer additional services, governmental authorities may decide to impose additional regulation and taxes upon providers of Internet service. All of these could inhibit our ability to remain a low cost carrier.

Much of the law related to the liability of Internet service providers remains unsettled. For example, many jurisdictions have adopted laws related to unsolicited commercial email or spam in the last several years. Other legal issues, such as the sharing of copyrighted information, transborder data flow, universal service, and liability for software viruses could become subjects of additional legislation and legal development. We cannot predict the impact of these changes on us. Regulatory changes could have a material adverse effect on our business, financial condition or results of operations.

Terrorist activity throughout the world and military action to counter terrorism could adversely impact our business.

The September 11, 2001 terrorist attacks in the United States and the continued threat of terrorist activity and other acts of war or hostility have had, and may continue to have, an adverse effect on business, financial and general economic conditions internationally. Effects from these events and any future terrorist activity, including cyber terrorism, may, in turn, increase our costs due to the need to provide enhanced security, which would adversely affect our business and results of operations. These circumstances may also damage or destroy the Internet infrastructure and may adversely affect our ability to attract and retain customers, our ability to raise capital and the operation and maintenance of our network access points. We are particularly vulnerable to acts of terrorism because our largest customer concentration is located in New York, our headquarters is in Washington, D.C., and we have significant operations in Paris and Madrid, cities that have historically been targets for terrorist attacks.

ITEM 2. DESCRIPTION OF PROPERTIES

We lease and own space for offices, data centers, colocation facilities, and points-of-presence.

Our headquarters facilities consist of approximately 15,370 square feet located in Washington, D.C. The lease for our headquarters is with an entity controlled by our Chief Executive Officer. The lease expires on August 31, 2010.

We also lease approximately 376,000 square feet of space in 58 locations to house our colocation facilities, regional offices and operations centers. The remaining term of these leases ranges from 6 months to 9 years with, in many cases, options to renew.

We believe that these facilities are generally in good condition and suitable for our operations.

ITEM 3. LEGAL PROCEEDINGS

We are involved in legal proceedings in the normal course of our business that we do not expect to have a material adverse affect on our business, financial condition or results of operations. For a discussion of the significant proceedings in which we are involved, see Note 7 to our consolidated financial statements.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.

No matters were submitted to a vote of our security holders during the quarter ended December 31, 2006.

PART II

ITEM 5. MARKET FOR THE REGISTRANT S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

Our sole class of common equity is our common stock, par value $0.001, which is currently traded on the NASDAQ Global Market under the symbol CCOI . Prior to March 6, 2006, our common stock traded on the American Stock Exchange under the symbol COI . Prior to February 5, 2002 no established public trading market for our common stock existed.

As of March 1, 2007, there were approximately 135 holders of record of shares of our common stock holding 49,005,223 shares of our common stock.

The table below shows, for the quarters indicated, the reported high and low trading prices of our common stock.

	High	Low
Calendar Year 2005		
First Quarter	$ 25.40	$ 8.11
Second Quarter	28.30	6.29
Third Quarter	8.37	4.56
Fourth Quarter	6.16	4.18
Calendar Year 2006		
First Quarter	$ 9.77	$ 5.13
Second Quarter	12.41	7.79
Third Quarter	11.77	7.78
Fourth Quarter	17.00	11.14

We have not paid any dividends on our common stock since our inception and do not anticipate paying any dividends in the foreseeable future. Our line of credit prohibits the payment of dividends. Any future determination to pay dividends will be at the discretion of our board of directors and will be dependent upon then-existing conditions, including our financial condition, results of operations, contractual restrictions, capital requirements, business prospects and other factors our board of directors deems relevant.

Performance Graph

The Company, in connection with its merger with Allied Riser Communications Corporation, began trading shares of its common stock on the American Stock Exchange in February 2002. On March 6, 2006, the Company s shares of Common Stock began trading on the Nasdaq National Market. The chart below compares the relative changes in the cumulative total return of the Company s Common Stock for the period February 5, 2002 - December 31, 2006, against the cumulative total return for the same period of the (1) The Standard & Poors 500 (S&P 500) Index and (2) an industry peer group consisting of Savvis Communications Corporation (NASDAQ: SVVS); Internap Network Services Corporation (AMEX: IIP); and Time Warner Telecom Inc. (NASDAQ: TWTC). The comparison assumes $100 was invested on February 5, 2002 in the Company s common stock, the S&P 500 Index and the industry peer group, with dividends, if any, reinvested.

COMPARISON OF 59 MONTH CUMULATIVE TOTAL RETURN*
AMONG COGENT COMMUNICATIONS GROUP, THE S & P INDEX
AND A PEER GROUP

Value of $100 Invested on February 5, 2002.

	2/02	12/02	12/03	12/04	12/05	12/06
Cogent Communications Group	100.00	7.52	23.17	21.39	5.44	16.06
S&P 500	100.00	79.05	101.73	112.80	118.34	137.03
Peer Group	100.00	24.89	127.76	56.33	58.70	159.07

* $100 invested on 2/5/02 in stock or on 1/31/02 in index including reinvestment of dividends. Fiscal year ending December 31.

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ITEM 6. SELECTED CONSOLIDATED FINANCIAL DATA

The annual financial information set forth below has been derived from our audited consolidated financial statements. The information should be read in connection with, and is qualified in its entirety by reference to, Management s Discussion and Analysis, the consolidated financial statements and notes included elsewhere in this report and in our SEC filings.

	Years Ended December 31,				
	2002	2003	2004	2005	2006
	(dollars in thousands)				
CONSOLIDATED STATEMENT OF OPERATIONS DATA:					
Service revenue, net	$ 51,913	$ 59,422	$ 91,286	$ 135,213	$ 149,071
Operating expenses:					
Network operations	49,091	47,017	63,466	85,794	80,106
Equity-based compensation expense network operations	233	1,307	858	399	315
Selling, general, and administrative	33,495	26,570	40,382	41,344	46,593
Equity-based compensation expense SG&A	3,098	17,368	11,404	12,906	10,194
Gain on settlement of vendor litigation	(5,721)				
Terminated public offering costs			779		
Restructuring charges			1,821	1,319	
Depreciation and amortization	33,990	48,387	56,645	55,600	58,414
Total operating expenses	114,186	140,649	175,355	197,362	195,622
Operating loss	(62,273)	(81,227)	(84,069)	(62,149)	(46,551)
Settlement of note holder litigation	(3,468)				
Gains lease obligation restructurings			5,292	844	255
Gain Allied Riser note exchange		24,802			
Gains Cisco credit facility		215,432		842	
Gains dispositions of assets				3,372	254
Interest income (expense) and other, net	(34,545)	(18,264)	(10,883)	(10,427)	(7,715)
(Loss) income before extraordinary gain	(100,286)	140,743	(89,660)	(67,518)	(53,757)
Extraordinary gain Allied Riser merger	8,443				
Net (loss) income	(91,843)	140,743	(89,660)	(67,518)	(53,757)
Beneficial conversion charges		(52,000)	(43,986)		
Net (loss) income applicable to common shareholders	$ (91,843)	$ 88,743	$ (133,646)	$ (67,518)	$ (53,757)
Net (loss) income per common share available to common shareholders basic	$ (564.45)	$ 11.18	$ (175.03)	$ (1.96)	$ (1.16)
Net (loss) income per common share available common shareholders diluted	$ (564.45)	$ 11.18	$ (175.03)	$ (1.96)	$ (1.16)
Weighted-average common shares basic	162,712	7,935,831	763,540	34,439,937	46,343,372
Weighted-average common shares diluted	162,712	7,938,838	763,540	34,439,937	46,343,372
CONSOLIDATED BALANCE SHEET DATA (AT PERIOD END):					
Cash and cash equivalents	$ 39,314	$ 7,875	$ 13,844	$ 29,883	$ 42,642
Total assets	407,677	344,440	378,586	351,373	336,876
Long-term debt (including capital leases and current portion) (net of unamortized discount of $6,084 in 2003, $5,026 in 2004, $3,478 in 2005 and $1,213 in 2006)	347,930	83,702	126,382	99,105	97,024
Preferred stock	175,246	97,681	139,825		
Stockholders equity	32,626	244,754	212,490	221,001	215,632
OTHER OPERATING DATA:					
Net cash (used in) provided by operating activities	(41,567)	(27,357)	(26,425)	(9,062)	5,285
Net cash used in investing activities	(19,786)	(25,316)	(2,701)	(14,055)	(19,478)
Net cash provided by financing activities	51,694	20,562	34,486	39,824	27,045

ITEM 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

You should read the following discussion and analysis together with Selected Consolidated Financial and Other Data and our consolidated financial statements and related notes included in this report. The discussion in this report contains forward-looking statements that involve risks and uncertainties, such as statements of our plans, objectives, expectations and intentions. The cautionary statements made in this report should be read as applying to all related forward-looking statements wherever they appear in this report. Our actual results could differ materially from those discussed here. Factors that could cause or contribute to these differences include those discussed in Risk Factors, as well as those discussed elsewhere. You should read Risk Factors and Special Note Regarding Forward-Looking Statements.

General Overview

We are a leading facilities-based provider of low-cost, high-speed Internet access and IP communications services. Our network is specifically designed and optimized to transmit data using IP. IP networks are significantly less expensive to operate and are able to achieve higher performance levels than the traditional circuit-switched networks used by our competitors, thus giving us cost and performance advantages in our industry. We deliver our services to small and medium-sized businesses, communications service providers and other bandwidth-intensive organizations through approximately 12,300 customer connections in North America and Western Europe. Our primary on-net service is Internet access at a speed of 100 Megabits per second, much faster than typical Internet access currently offered to businesses. We offer this on-net service exclusively through our own facilities, which run all the way to our customers premises.

Our network is comprised of in-building riser facilities, metropolitan optical fiber networks, metropolitan traffic aggregation points and inter-city transport facilities. The network is physically connected entirely through our facilities to over 1,100 buildings in which we provide our on-net services, including over 850 multi-tenant office buildings. We also provide on-net services in carrier-neutral colocation facilities, data centers and single-tenant office buildings. Because of our integrated network architecture, we are not dependent on local telephone companies to serve our on-net customers. We emphasize the sale of on-net services because we believe we have a competitive advantage in providing these services and our sales of these services generate higher gross profit margins.

We also provide Internet connectivity to customers that are not located in buildings directly connected to our network. We serve these off-net customers using other carriers facilities to provide the last mile portion of the link from our customers premises to our network. We also provide certain non-core services which are legacy services which we acquired and continue to support but do not actively sell.

We believe our key opportunity is provided by our high-capacity network, which provides us with the ability to add a significant number of customers to our network with minimal incremental costs. Our focus is to add customers to our network in a way that maximizes its use and at the same time provides us with a customer mix that produces strong profit margins. We are responding to this opportunity by increasing our sales and marketing efforts including increasing our number of sales representatives. In addition, we may add customers to our network through strategic acquisitions.

We plan to expand our network to locations that can be economically integrated and represent significant concentrations of Internet traffic. We may identify locations that we desire to serve with our on-net product but cannot be cost effectively added to our network. One of our keys to developing a profitable business will be to carefully match the expense of extending our network to reach new customers with the revenue generated by those customers.

We believe the two most important trends in our industry are the continued growth in Internet traffic and a decline in Internet access prices. As Internet traffic continues to grow and prices per unit of traffic continue to decline, we believe our ability to load our network and gain market share from less efficient network operators will expand. However, continued erosion in Internet access prices will likely have a negative impact on the rate at which we can increase our revenues and our profit margins.

We have grown our net service revenue from $91.3 million for the year ended December 31, 2004 to $149.1 million for the year ended December 31, 2006. We have generated our revenue growth through the strategic acquisitions of communications network assets and customers, primarily from financially distressed companies, the continued expansion of our network of on-net buildings and the increase in customers generated by our sales and marketing efforts.

Our on-net service consists of high-speed Internet access and IP connectivity ranging from 0.5 Megabits per second to 10 Gigabits per second of bandwidth. We offer our on-net services to customers located in buildings that are physically connected to our network. Off-net services are sold to businesses that are connected to our network primarily by means of T1, T3, E1 and E3 lines obtained from other carriers. Our non-core services, which consist of legacy services of companies whose assets or businesses we have acquired, include managed modem services, email, retail dial-up Internet access, shared web hosting, managed web hosting, managed security, voice services (only provided in Toronto, Canada) and point to point private line services. We do not actively market these non-core services and expect the net service revenue associated with them to continue to decline.

Our on-net, off-net and non-core services comprised 57.9%, 33.0% and 9.1% of our net service revenue, respectively, for the year ended December 31, 2005 and 70.6%, 23.1% and 6.3% for the year ended December 31, 2006. While we target our sales and marketing efforts at increasing on-net customers, customers we add through acquisitions will also affect the mix of on-net and off-net revenues. For example, off-net service revenue increased as a percentage of total revenue in 2005 as compared to 2004 due to the inclusion of a full year of revenue from customers we added through our December 2004 acquisition of the off-net Internet access customers of Verio, Inc. We expect the percentage of on-net revenues to continue to increase as a percentage of total revenues in 2007.

We have grown our gross profit from $27.8 million for the year ended December 31, 2004 to $69.0 million for the year ended December 31, 2006. Our gross profit margin has expanded from 30.5% in 2004 to 46.3% for the year ended December 31, 2006. We determine gross profit by subtracting network operation expenses (excluding equity-based compensation expense) from our net service revenue. Equity-based compensation expense classified as cost of network services was $0.9 million, $0.4 million and $0.3 million for the years ended December 31, 2004, 2005 and 2006, respectively. We believe that our gross profit will benefit and continue to expand as we are allocating the majority of our sales resources toward obtaining additional on-net customers and as sales of these services generate higher gross profit margins than our off-net and non-core services. We believe that as we add on-net customers we incur limited incremental expenses. We have not allocated depreciation and amortization expense to our network operations expense.

Due to our strategic acquisitions of network assets and equipment, we believe we are positioned to grow our revenue base and profitability without significant additional capital investments. We continue to deploy network equipment to other parts of our network to maximize the utilization of our assets. As a result, our future capital expenditures will be based primarily on our planned expansion of on-net buildings and the concentration and growth of our customer base. We expect our 2007 capital expenditure rate to be similar to the rate we experienced for 2006. We plan to increase our number of on-net buildings to approximately 1,160 by December 31, 2007 from 1,107 at December 31, 2006.

Historically, our operating expenses have exceeded our net service revenue resulting in operating losses of $84.1 million, $62.1 million and $46.6 million in 2004, 2005 and 2006, respectively. In each of these periods, our operating expenses consisted primarily of the following:

- Network operations expenses which consist primarily of the cost of leased circuits, sites and facilities; tenant license agreements, network maintenance expenses, and salaries of, and expenses related to, employees who are directly involved with maintenance and operation of our network.

- Selling, general and administrative expenses which consist primarily of salaries, commissions and related benefits paid to our employees and related selling and administrative costs including bad debt expense and professional fees.

- Depreciation and amortization expenses which result from the depreciation of our property and equipment, including the assets associated with our network and the amortization of our intangible assets.

- Equity-based compensation expense that results from the expense related to certain stock options and our restricted stock granted to our employees.

- Restructuring charges that resulted from the termination of our Paris office lease.

Acquisitions

Since our inception, we have consummated 13 acquisitions through which we have generated revenue growth, expanded our network and customer base and added strategic assets to our business. We have accomplished this primarily by acquiring financially distressed companies or their assets at a significant discount to their original cost. The overall impact of these acquisitions on the operation of our business has been to extend the physical reach of our network in both North America and Western Europe, expand the breadth of our service offerings, and increase the number of customers to whom we provide our services. The overall impact of these acquisitions on our balance sheet and cash flows has been to significantly increase the assets on our balance sheet, including cash in the case of the Allied Riser merger, increase our indebtedness and increase our cash flows from operations due to our increased customer base. A substantial portion of our historical growth in net service revenue and specifically off-net and non-core revenues has been generated by the customer contracts we have acquired. Following an acquisition, we have historically experienced a decline in revenue attributable to acquired customers as these customers contracts have expired and they have entered into standard Cogent customer contracts at generally lower rates or have chosen not to renew service with us. We anticipate that we will experience similar declines with respect to customers we have acquired or will acquire.

Acquisition of Verio

In December 2004, we acquired most of the off-net Internet access customers of Verio Inc., a leading global IP provider and subsidiary of NTT Communications Corp. The acquired assets included over 3,700 primarily off-net customer connections located in 23 of our U.S. markets, customer accounts receivable and certain network equipment. We also assumed the liabilities associated with providing services to these customers including vendor relationships, accounts payable, and accrued liabilities.

Acquisition of Aleron

In October 2004, we acquired certain assets of Aleron Broadband Services, formally known as AGIS Internet, and $18.5 million in cash, in exchange for 3,700 shares of our Series M preferred stock, which converted into approximately 5.7 million shares of our common stock in February 2005. We acquired Aleron s customer base and network, as well as Aleron s Internet access and managed modem services.

Acquisition of Global Access

In September 2004, we acquired the majority of the assets of Global Access Telecommunications, Inc. in exchange for 185 shares of our Series L preferred stock. The Series L preferred stock issued in the transaction converted into approximately 0.3 million shares of our common stock in February 2005. Global Access provided Internet access and other data services in Germany. We acquired over 350 customer connections in Germany as a result of the acquisition.

Acquisition of UFO

In August 2004, we acquired certain assets of Unlimited Fiber Optics, Inc., or UFO, for 2,600 shares of our Series K preferred stock. The preferred stock issued in the merger converted into approximately 0.8 million shares of our common stock in February 2005. Among these assets were UFO s customer base, which was comprised of data service customers located in San Francisco and Los Angeles. The acquired assets also included net cash of approximately $1.9 million and customer accounts receivable.

Acquisition of European Networks

In 2004 we expanded our operations into Europe through a series of acquisitions in which we acquired customers and extended our network, primarily in France, Spain, and Germany. We began operating in France and Spain through the acquisition of subsidiaries of LNG Holdings SA, or LNG, an operator of a European telecommunications network that was on the verge of insolvency. In March 2004, we acquired network assets in Germany formerly operated as part of the Carrier 1 network.

Results of Operations

Our management reviews and analyzes several key performance indicators in order to manage our business and assess the quality of and potential variability of our net service revenues and cash flows. These key performance indicators include:

- net service revenues, which are an indicator of our overall business growth and the success of our sales and marketing efforts;

- gross profit, which is an indicator of both our service offering mix, competitive pricing pressures and the cost of our network operations;

- growth in our on-net customer base, which is an indicator of the success of our on net focused sales efforts;

- growth in our on-net buildings; and

- distribution of revenue across our service offerings.

Year Ended December 31, 2005 Compared to the Year Ended December 31, 2006

The following summary table presents a comparison of our results of operations for the year ended December 31, 2005 and 2006 with respect to certain key financial measures. The comparisons illustrated in the table are discussed in greater detail below.

	Year Ended December 31, 2005 (in thousands)	2006	Percent Change
Net service revenue	$ 135,213	$ 149,071	10.2 %
Network operations expenses(1)	85,794	80,106	(6.6)%
Gross profit(2)	49,419	68,965	39.6 %
Selling, general, and administrative expenses(3)	41,344	46,593	12.7 %
Restructuring charges	1,319		(100.0)%
Depreciation and amortization expenses	55,600	58,414	5.1 %
Gains lease obligations, debt restructurings and asset sales	5,058	509	(89.9)%
Net loss	(67,518)	(53,757)	(20.4)%

(1) Excludes equity-based compensation expense of $399 and $315 in the years ended December 31, 2005 and 2006, respectively, which, if included would have resulted in a period-to-period change of (6.7)%.

(2) Excludes equity-based compensation expense of $399 and $315 in the years ended December 31, 2005 and 2006, respectively, which if included would have resulted in a period-to-period change of 40.0%.

(3) Excludes equity-based compensation expense of $12,906 and $10,194 in the years ended December 31, 2005 and 2006, respectively, which, if included would have resulted in a period-to-period change of 4.7%.

Net Service Revenue. Our net service revenue increased 10.2% from $135.2 million for the year ended December 31, 2005 to $149.1 million for the year ended December 31, 2006. For the years ended December 31, 2005 and 2006, on-net, off-net and non-core revenues represented 57.9%, 33.0% and 9.1% and 70.6%, 23.1% and 6.3% of our net service revenues, respectively.

Our on-net revenues increased 34.4% from $78.3 million for the year ended December 31, 2005 to $105.3 million for the year ended December 31, 2006. Our on-net revenues increased as we increased the number of our on-net customer connections from approximately 4,700 at December 31, 2005 to approximately 7,800 at December 31, 2006. On-net customer connections increased at a greater rate than on-net revenues due to a decline in the revenue per on-net customer connection, which we expect to continue. This decline is partly attributed to a shift in the customer connection mix. Due to the increase in the size of our sales force, we are now able to focus not only on customers who purchase high-bandwidth connections, as we have done historically, but also on customers who purchase lower-bandwidth connections. We expect to continue to focus our sales efforts on such a broad mix of customers. Additionally, on-net customers who cancel their service from our installed base of customers, in general, have a greater revenue per connection than new customers. These trends result in a lower revenue per on-net connection. We believe that our on-net revenues as a percentage of total revenues will continue to increase as we are allocating the majority of our sales and marketing resources toward obtaining additional on-net customers. Our off-net revenues decreased 22.9% from $44.6 million for the year ended December 31, 2005 to $34.4 million for the year ended December 31, 2006 primarily because our December 2004 acquisition of off-net customers from Verio resulted in a substantial increase in the number of our off-net customers in 2005 and many of these acquired customers have either cancelled service or re-priced their contracts at lower rates. Our off-net customer connections declined from approximately 4,000 at December 31, 2005 to approximately 3,500 at December 31, 2006. We expect that the net loss of off-net customer connections will continue. Our non-core revenues decreased 23.4% from $12.2 million for the year ended December 31, 2005 to $9.4 million for the year ending December 31, 2006. The number of our non-core customer connections declined from approximately 1,300 at December 31,

2005 to approximately 1,000 at December 31, 2006. We do not actively market these acquired non-core services and expect that the net service revenue associated with them will continue to decline.

Network Operations Expenses. Our network operations expenses, excluding equity-based compensation expense, decreased 6.6% from $85.8 million for the year ended December 31, 2005 to $80.1 million for the year ended December 31, 2006. The decrease is primarily attributable to a decline in leased circuit costs related to the decline in off-net revenues. We provide Internet connectivity to our off-net customers using other carriers facilities to provide the last mile portion of the link from our customers premises to our network and incur leased circuit costs to provide these services.

Gross Profit. Our gross profit, excluding equity-based compensation expense, increased 39.6% from $49.4 million for the year ended December 31, 2005 to $69.0 million for the year ended December 31, 2006. We determine gross profit by subtracting network operations expenses from our net service revenue (excluding equity-based compensation expense) and do not allocate depreciation and amortization expense to our network operations expense. The increase is primarily attributed to the increase in higher gross margin on-net revenues as a percentage of net service revenue. Our gross profit margin expanded from 36.5% for the year ended December 31, 2005 to 46.3% for the year ended December 31, 2006. Our gross profit has benefited from the limited incremental expenses associated with providing service to an increasing number of on-net customers and the decline in off-net revenues which carry a lower gross margin due to the associated leased circuit required to provide this service. Our gross profit margin may be impacted by the timing and amounts of disputed circuit costs. We generally record these disputed amounts when billed by the vendor and reverse these amounts when the vendor credit has been received or the dispute has been otherwise resolved. We believe that our gross profit margin will continue to increase as we are allocating the majority of our sales and marketing resources toward obtaining additional on-net customers and as sales of these services generate higher gross profit margins than our off-net and non-core services.

Selling, General, and Administrative Expenses (SG&A). Our SG&A expenses, excluding equity-based compensation expense, increased 12.7% from $41.3 million for the year ended December 31, 2005 to $46.6 million for the year ended December 31, 2006. SG&A expenses increased primarily from the increase in salaries and related costs required to support our expanding sales and marketing efforts.

Equity-based Compensation Expense. Equity-based compensation expense is related to restricted stock and stock options. The total equity-based compensation expense decreased 21.0% from $13.3 million for the year ended December 31, 2005 to $10.5 million for the year ending December 31, 2006. The decrease is primarily attributed to a $3.4 million decrease in equity based compensation expense associated with the amortization of compensation expense for certain 2003 restricted stock grants which ended in August 2006 when these shares became fully vested. Equity-based compensation expense for the year ended December 31, 2006 includes $0.7 million in compensation costs associated with the adoption of Statement No. 123 (revised 2004), *Share-Based Payment* (SFAS 123(R)) on January 1, 2006 using the modified-prospective-transition method. As of December 31, 2006 there was approximately $5.5 million of total unrecognized compensation cost related to non-vested equity-based compensation awards. That cost is expected to be recognized over a weighted average period of approximately twenty-seven months.

Depreciation and Amortization Expenses. Our depreciation and amortization expense increased 5.1% from $55.6 million for the year ended December 31, 2005 to $58.4 million for the year ended December 31, 2006 due to an increase in deployed fixed assets. In the fourth quarter of 2005, we revised the number of lease renewal periods used in determining the lease term for purposes of amortizing certain of our leasehold improvements. This resulted in a net increase in depreciation expense of approximately $3.0 million.

Restructuring charges. In 2004, we abandoned the Paris office obtained in the Cogent Europe acquisition and located these operations in another Cogent Europe facility. We recorded a restructuring charge of approximately $1.8 million

related to the discounted remaining commitment on the lease, net of estimated sublease income. In the third quarter of 2005, we revised our estimate for sublease income, and recorded an additional $1.3 million restructuring charge.

Gains- lease obligations, asset sales and debt restructurings. In September 2005, Cogent Spain negotiated modifications to an IRU capital lease that reduced its quarterly IRU lease payments and extended the lease term. The modification to the IRU capital lease resulted in a gain of approximately $0.8 million. In June 2005, we repaid our $17.0 million amended and restated Cisco note. The repayment resulted in a gain of $0.8 million representing the amount of the estimated future interest payments that was not required to be paid. In 2005, we sold a building and land for net proceeds of $5.1 million. This sale resulted in a gain of approximately $3.9 million.

In September 2006, Cogent Spain negotiated modifications to an IRU capital lease that reduced its quarterly IRU lease payments and extended the lease term. The modification to this IRU capital lease resulted in a gain of approximately $0.3 million. In 2006, we sold another building and land for net proceeds of $0.8 million. This sale resulted in a gain of approximately $0.3 million.

Net Loss. Our net loss was $67.5 million for the year ended December 31, 2005 as compared to a net loss of $53.8 million for the year ended December 31, 2006. Our net loss decreased by $13.8 million primarily due to a $19.5 million increase in our gross profit partially offset by a $5.2 million increase in SG&A, and a $2.8 million increase in depreciation and amortization expense. Included in net loss for the year ended December 31, 2005 is a $1.3 million restructuring charge and gains of approximately $5.1 million. Included in net loss for the year ended December 31, 2006 are gains of approximately $0.5 million.

Buildings On-net. As of December 31, 2005 and 2006 we had a total of 1,040 and 1,107 on-net buildings connected to our network, respectively.

Year Ended December 31, 2004 Compared to the Year Ended December 31, 2005

The following summary table presents a comparison of our results of operations for the year ended December 31, 2004 and 2005 with respect to certain key financial measures. The comparisons illustrated in the table are discussed in greater detail below.

	Year Ended December 31, 2004 (in thousands)	**2005**	**Percent Change**
Net service revenue	$ 91,286	$ 135,213	48.1 %
Network operations expenses(1)	63,466	85,794	35.2 %
Gross profit(2)	27,820	49,419	77.6 %
Selling, general, and administrative expenses(3)	40,382	41,344	2.4 %
Restructuring charges	1,821	1,319	(27.6)%
Terminated public offering costs	779		(100.0)%
Depreciation and amortization expenses	56,645	55,600	(1.8)%
Gains lease obligations, asset sales and debt restructurings	5,292	5,058	(4.4)%
Net loss	(89,660)	(67,518)	(24.7)%

(1) Excludes equity-based compensation expense of $858 and $399 in the years ended December 31, 2004 and 2005, respectively, which, if included would have resulted in a period-to-period change of 34.0%.

(2) Excludes equity-based compensation expense of $858 and $399 in the years ended December 31, 2004 and 2005, respectively, which if included would have resulted in a period-to-period change of 81.8%.

(3) Excludes equity-based compensation expense of $11,404 and $12,906 in the years ended December 31, 2004 and 2005, respectively, which, if included would have resulted in a period-to-period change of 4.8%.

Net Service Revenue. Our net service revenue increased 48.1% from $91.3 million for the year ended December 31, 2004 to $135.2 million for the year ended December 31, 2005. For the years ended December 31, 2004 and 2005, on-net, off-net and non-core revenues represented 63.5%, 24.4% and 12.1% and 57.9%, 33.0% and 9.1% of our net service revenues, respectively. Off-net service revenue increased as a percentage of total revenue in 2005 as compared to 2004 primarily due to the inclusion of a full year of revenue from customers we added through our December 2004 acquisition of the off-net Internet access customers of Verio.

Our on-net revenues increased 35.2% from $57.9 million for the year ended December 31, 2004 to $78.3 million for the year ended December 31, 2005. Our on-net revenues increased as we increased the number of our on-net customer connections from approximately 2,800 at December 31, 2004 to approximately 4,700 at December 31, 2005. Notwithstanding the increase in on-net revenues, the percentage of on-net revenues of total revenues decreased from 2004 to 2005 due to the increase in off-net revenues from the acquisition of the off-net Internet access customers of Verio. We believe that our on-net revenues as a percentage of total revenues will increase as we are allocating the majority of our sales resources toward obtaining additional on-net customers. Our off-net revenues increased 100.4% from $22.3 million for the year ended December 31, 2004 to $44.6 million for the year ended December 31, 2005. Our off-net revenues increased as we increased the number of our off-net customer connections during 2005 primarily from the December 2004 Verio acquisition. Due primarily to the churn of these acquired customers during 2005, however, our off-net customer connections declined from approximately 4,500 at December 31, 2004 to approximately 4,000 at December 31, 2005. We expect that this loss of our off-net customer connections will continue. Our non-core revenues increased 10.5% from $11.1 million for the year ended December 31, 2004 to $12.2 million for the year ending December 31, 2005. Our non-core revenues increased as we added non-core managed modem customer connections from our October 2004 Aleron acquisition and certain non-core Verio customers in that December 2004 acquisition. The number of our non-core customer connections declined from approximately 1,800 at December 31, 2004 to approximately 1,300 at December 31, 2005. We do not actively market these acquired non-core services and expect that the net service revenue associated with them will decline.

Our net service revenue related to our acquisitions is included in our statements of operations from the acquisition dates. Acquired net service revenues from our UFO, Global Access, Aleron and Verio acquisitions, which occurred in August 2004, September 2004, October 2004 and December 2004, respectively, totaled $6.9 million for the year ended December 31, 2004 and $35.5 million for the year ended December 31, 2005, respectively. This increase is primarily due to the $21.7 million increase in acquired revenues from the December 2004 Verio acquisition. Approximately $2.0 million of our non-core Cogent Europe net service revenue during 2004 was derived from network sharing services rendered to LambdaNet Communications Deutschland AG, or LambdaNet Germany. LambdaNet Germany was majority-owned by LNG Holdings until April 2004 when it was sold to an unrelated third party. In the first quarter of 2005, this network sharing arrangement was terminated and there was no such revenue in 2005.

Network Operations Expenses. Our network operations expenses, excluding equity-based compensation expense, increased 35.2% from $63.5 million for the year ended December 31, 2004 to $85.8 million for the year ended December 31, 2005. The increase is primarily attributable to leased circuits and facilities costs incurred in connection with our 2004 acquisitions. We provide Internet connectivity to the acquired customers that are not located in buildings directly connected to our network. As a result we serve these off-net customers using other carriers facilities to provide the last mile portion of the link from our customers premises to our network and incur leased circuit costs to provide these services. Additionally, for the year ended December 31, 2004, Cogent Europe recorded $1.8 million of costs associated with using the LambdaNet Germany network. In 2005 this network sharing arrangement was terminated and there were no such costs in 2005.

Gross profit. Our gross profit, excluding equity-based compensation expense, increased 77.6% from $27.8 million for the year ended December 31, 2004 to $49.4 million for the year ended December 31, 2005. The $21.6 million increase is primarily attributed to our increase in net service revenue. Our gross profit margin expanded from 30.5% in 2004 to 36.5% for the year ended December 31, 2005. We determine gross profit by subtracting network operation expenses from our net service revenue (excluding equity-based compensation expense). Our gross profit has benefited from the limited incremental expenses associated with providing service to an increasing number of on-net customers. We have not allocated depreciation and amortization expense to our network operations expense. Our gross profit margin may be impacted by the timing and amounts of disputed circuit costs. We generally record these disputed amounts when billed by the vendor and reverse these amounts when the vendor credit has been received or the dispute has been otherwise resolved. We believe that our gross profit margin will increase as we are allocating the majority of our sales resources toward obtaining additional on-net customers and as sales of these services generate higher gross profit margins than our off-net and non-core services.

Selling, General, and Administrative Expenses. Our SG&A expenses, excluding equity-based compensation expense, increased 2.4% from $40.4 million for the year ended December 31, 2004 to $41.3 million for the year ended December 31, 2005. SG&A expenses increased primarily from the $2.8 million increase in salaries and related costs required to support our sales effort and an increase of approximately $0.5 million of auditor fees associated with our Sarbanes-Oxley Section 404 compliance requirements.

Equity-based Compensation Expense. Equity-based compensation expense is primarily related to restricted stock granted to our employees. Equity-based compensation expense increased from $12.3 million for the year ended December 31, 2004 to $13.3 million for the year ending December 31, 2005. The increase is primarily attributed to approximately $0.6 million of deferred compensation expense recorded in 2005 from the grant of additional restricted shares in 2005 and the amortization expense related to $4.7 million of deferred compensation related to options for restricted stock. These options were granted to certain of our employees in the third quarter of 2004 with an exercise price below the trading price of our common stock on the grant date. Compensation costs are recorded on a straight-line basis over the service period.

Restructuring charges. In 2004, Cogent France re-located its Paris headquarters. The estimated net present value of the remaining lease obligation, net of estimated sublease income, was approximately $1.8 million and was recorded as a restructuring charge in 2004. In the third quarter of 2005, we revised our estimate for sublease income and estimated that the net present value of the remaining lease obligation increased by approximately $1.3 million and recorded an additional restructuring charge.

Withdrawal of Public Offering. In May 2004, we filed a registration statement to sell shares of common stock in a public offering. In October 2004, we withdrew this registration statement and expensed the associated deferred costs of approximately $0.8 million.

Depreciation and Amortization Expenses. Our depreciation and amortization expense decreased 1.8% from $56.6 million for the year ended December 31, 2004 to $55.6 million for the year ended December 31, 2005. The decrease is primarily attributed to a $6.3 million decrease in the amortization expense of intangible assets that were fully amortized in 2005. In addition, in the fourth quarter of 2005, we revised the number of lease renewal periods used in determining the lease term for purposes of amortizing certain of our leasehold improvements. This resulted in a net increase in depreciation expense of approximately $3.0 million.

Gains Lease Obligations, Asset Sales and Debt Restructurings. In 2004, we renegotiated several capital lease obligations for our intra-city fiber in France and Spain. These transactions resulted in gains of approximately $5.3 million recorded as gains on lease obligation restructurings for the year ended December 31, 2004.

In March 2005, we sold our building and land located in Lyon, France for net proceeds of $5.1 million. These assets were acquired in the Cogent Europe acquisition. This transaction resulted in a gain of approximately $3.9 million. In June 2005, we used a portion of the proceeds from our public offering to repay our $17.0 million Amended and Restated Cisco Note. The repayment of the Amended and Restated Cisco Note resulted in a gain of $0.8 million representing the amount of the estimated future interest payments that was not required to be paid. In September 2005, we re-negotiated a capital lease obligation for our intra-city fiber in Spain. The modification to the IRU capital lease resulted in a gain of approximately $0.8 million.

Net Loss. Our net loss was $89.7 million for the year ended December 31, 2004 as compared to a net loss of $67.5 million for the year ended December 31, 2005. The $22.2 million reduction in our net loss occurred primarily due to the $21.6 million increase in our gross margin.

Buildings On-net. As of December 31, 2004 and 2005 we had a total of 989 and 1,040 on-net buildings connected to our network, respectively.

Liquidity and Capital Resources

In assessing our liquidity, management reviews and analyzes our current cash balances, short-term investments, accounts receivable, accounts payable, capital expenditure commitments, and required capital lease and debt payments and other obligations.

Cash Flows

The following table sets forth our consolidated cash flows for the years ended December 31, 2004, 2005, and 2006.

	Year Ended December 31,		
	2004	2005	2006
	(in thousands)		
Net cash (used in) provided by operating activities	$ (26,425)	$ (9,062)	$ 5,285
Net cash used in investing activities	(2,701)	(14,055)	(19,478)
Net cash provided by financing activities	34,486	39,824	27,045
Effect of exchange rates on cash	609	(668)	(93)
Net increase in cash and cash equivalents during period	$ 5,969	$ 16,039	$ 12,759

Net Cash (Used in) Provided By Operating Activities. Net cash used in operating activities was $9.1 million for the year ended December 31, 2005 compared to net cash provided by operating activities of $5.3 million for 2006. The change is primarily due to the increase in gross margin dollars generated from our increase in revenues. Our primary sources of operating cash are receipts from our customers who are billed on a monthly basis for our services. Our primary uses of operating cash are payments made to our vendors and employees. Our net loss was $67.5 million for the year ended December 31, 2005 compared to a net loss of $53.8 million for the year ended December 31, 2006. Net loss for the year ended December 31, 2005 included non-cash gains of $4.8 million related to our restructuring of certain lease obligations, repayment of our Cisco note obligation and net gains on asset sales. Net loss for the year ended December 31, 2006 included non-cash gains of $0.5 million related to our restructuring of a lease obligation and asset sales. Depreciation and amortization, including the amortization of deferred compensation and the debt discount on the Allied Riser notes was $70.5 million for the year ended December 31, 2005, and $71.2 million for the year ended December 31, 2006. Net changes in operating assets and liabilities resulted in a decrease to operating cash of $7.2 million for the year ended December 31, 2005 and a decrease in operating cash of $11.6 million for the year ended December 31, 2006.

Net cash used in operating activities was $26.4 million for the year ended December 31, 2004 compared to $9.1 million for 2005. The reduction is primarily due to the increase in gross margin dollars generated from our increase in revenues. Our net loss was $89.7 million for the year ended December 31, 2004 compared to a net loss of $67.5 million for the year ended December 31, 2005. Net loss for the year ended December 31, 2004 included non-cash gains of $6.1 million related to our restructuring of certain lease obligations. Net loss for the year ended December 31, 2005 included non-cash gains of $4.8 million related to our restructuring of certain lease obligations, repayment of our Cisco note obligation and net gains on asset sales. Depreciation and amortization, including the amortization of deferred compensation and the debt discount on the Allied Riser notes was $70.0 million for the year ended December 31, 2004, and $70.5 million for the year ended December 31, 2005. Net changes in operating assets and liabilities resulted in a decrease to operating cash of $0.6 million for the year ended December 31, 2004 and a decrease in operating cash of $7.2 million for the year ended December 31, 2005.

Net Cash Used In Investing Activities. Net cash used in investing activities was $2.7 million for the year ended December 31, 2004, $14.1 million for the year ended December 31, 2005 and $19.5 million for the year ended December 31, 2006. Our primary uses of investing cash during 2004 were $10.1 million for the purchase of property and equipment and $1.9 million for the purchase of a network in Germany. Our primary uses of investing cash during 2005 were $17.3 million for the purchase of property and equipment, $0.9 million for the final payment on the purchase of a network in Germany and $0.8 million for the net purchases of short-term investments. Our primary uses of investing cash during 2006 were $21.5 million for the purchase of property and equipment. Our primary sources of investing cash in 2004 were $2.3 million of cash acquired from our acquisitions of Cogent Europe and Global Access and $7.4 million from the proceeds of the sale of assets and proceeds of short-term investments. Our primary source of investing cash in 2005 was $5.1 million from the proceeds of the sales of assets. Our primary sources of investing cash in 2006 were $1.2 million from the proceeds of short-term investments and $0.9 million from the proceeds of the sales of assets.

Net Cash Provided by Financing Activities. Financing activities provided net cash of $34.5 million for the year ended December 31, 2004, $39.8 million for the year ended December 31, 2005 and $27.0 million for the year ended December 31, 2006. Net cash from financing activities during 2004 resulted from $42.4 million of acquired cash related to our mergers with Symposium Gamma, Symposium Omega, UFO Group, and Cogent Potomac. Net cash used in financing activities for 2004 included a $1.2 million payment to LNG Holdings and $6.6 million in principal payments under our capital leases. Net cash from financing activities during 2005 resulted from $63.7 million of net proceeds from our June 2005 public offering, $10.0 million from the issuance of our subordinated note and $10.0 million borrowed under our credit facility. Net cash used in financing activities for 2005 included $17.0 million for the repayment of our Cisco note, $10.0 million for the repayment of our subordinated note, $10.0 million for the repayment of the amount outstanding under our credit facility and $6.9 million in principal payments under our capital leases. Net cash from financing activities during 2006 resulted from $36.5 million of net proceeds from our June 2006 public offering and $0.4 million from the proceeds from the exercises of stock options. Net cash used in financing activities for 2006 included $9.9 million in principal payments under our capital leases.

Cash Position and Indebtedness

Our total indebtedness, net of discount, at December 31, 2006 was $97.0 million and our total cash and cash equivalents and short-term investments were $42.7 million. Our total indebtedness at December 31, 2006 includes $88.0 million of capital lease obligations for dark fiber primarily under 15-25 year IRUs, of which approximately $6.0 million is considered a current liability. These capital lease obligations will be paid over a weighted average remaining term of approximately thirteen years.

Subordinated Note

On February 24, 2005, we issued a subordinated note in the principal amount of $10.0 million to Columbia Ventures Corporation in exchange for $10 million in cash. Columbia Ventures Corporation is owned by one of the Company s directors and shareholders. The terms of the subordinated note required the payment of all principal and accrued interest upon the occurrence of a liquidity event, which was defined as an equity offering of at least $30.0 million in net proceeds. Our June 2005 public offering was considered a liquidity event and in June 2005 we repaid the $10.0 million subordinated note, plus accrued interest of $0.3 million.

Credit Facility

On March 9, 2005, we entered into a $10.0 million credit facility with a commercial bank. The credit facility is secured by our accounts receivable and our other assets. In December 2005, we modified the credit facility, which increased the available borrowings to up to $20.0 million and removed a $4.0 million restricted cash covenant, among other revisions. The borrowing base is determined primarily by the aging characteristics related to our accounts receivable. In March 2005, we borrowed $10.0 million under the credit facility for working capital purposes. In June 2005, we repaid the $10.0 million with part of the proceeds of our June 2005 public offering. Borrowings under the credit facility accrue interest at the prime rate plus 1.5% and may, in certain circumstances, be reduced to the prime rate plus 0.5%. Our obligations under the credit facility are guaranteed by our material domestic subsidiaries. As of December 31, 2006, and since June 2005 there were no amounts outstanding under the credit facility. The credit facility expires on April 1, 2007. We do not plan to renew the credit facility.

Amended and Restated Cisco Note

We used a portion of the proceeds from our June 2005 public offering to repay in full the indebtedness under our $17.0 million amended and restated Cisco note. The Cisco recapitalization was considered a troubled debt restructuring under Statement of Financial Accounting Standards (SFAS) No. 15, *Accounting by Debtors and Creditors of Troubled Debt Restructurings.* Under SFAS No. 15, the note was recorded at its principal amount of $17.0 million plus the estimated future interest payments of $0.8 million. The estimated future interest was not required to be paid, so the payment of the note resulted in a gain of $0.8 million.

Allied Riser Convertible Subordinated Notes

Our 7.50% convertible subordinated notes are due on June 15, 2007. The $10.2 million of notes were recorded at their fair value of approximately $2.9 million at the merger date in 2002. The discount is amortized to interest expense through the maturity date. Interest is payable semiannually on June 15 and December 15.

Contractual Obligations and Commitments

The following table summarizes our contractual cash obligations and other commercial commitments as of December 31, 2006.

	Payments due by period				
	Total (in thousands)	Less than 1 year	1-3 years	3-5 years	After 5 years
Long term debt	$ 10,573	10,573			
Capital lease obligations	146,381	12,694	21,622	24,885	87,180
Operating leases(1)	152,642	28,319	39,373	24,184	60,766
Unconditional purchase obligations	1,163	1,163			
Total contractual cash obligations	$ 310,759	$ 52,749	$ 60,995	$ 49,069	$ 147,946

(1) These amounts include $153.7 million of operating lease, maintenance and tenant license agreement obligations, reduced by sublease agreements of $1.0 million.

Capital Lease Obligations. The capital lease obligations above were incurred in connection with IRUs for inter-city and intra-city dark fiber underlying substantial portions of our network. These capital leases are presented on our balance sheet at the net present value of the future minimum lease payments, or $88.0 million at December 31, 2006. These leases generally have terms of 15 to 25 years.

Letters of Credit. We are also party to letters of credit totaling $1.0 million at December 31, 2006. These obligations are fully secured by our restricted investments, and as a result, are excluded from the contractual cash obligations above.

Future Capital Requirements

We believe that our cash on hand and cash from operations will be adequate to meet our working capital, capital expenditure, debt service and other cash requirements if we execute our business plan. Our business plan includes increasing our number of on-net buildings to approximately 1,160 by December 31, 2007 from 1,107 at December 31, 2006 and continuing to substantially increase our number of sales representatives and our marketing efforts in 2007. Our business plan also assumes, among other things, the following:

- our ability to continue to increase the size of our on-net customer base;
- our ability to maintain our recent sales productivity performance and incremental sales product mix;
- our ability to locate and hire sales representatives according to our plan;
- our capital expenditure rate for 2007 will continue at a rate similar to the rate we experienced in 2006;
- no material changes to the conversion rate between the euro and the U.S. dollar and the Canadian dollar and the U.S. dollar;
- no material increases in our revenue churn rate;
- no material decline in our product pricing;
- no material increases in our customer bad debt; and
- our ability to add additional productive buildings to our network.

Any future acquisitions or other significant unplanned costs or cash requirements may require that we raise additional funds through the issuance of debt or equity. We cannot assure you that such financing will be available on terms acceptable to us or our stockholders, or at all. Insufficient funds may require us to delay or scale back the number of buildings that we serve, reduce our planned increase in our sales and marketing efforts, or require us to otherwise alter our business plan or take other actions that could have a material adverse effect on our business, results of operations and financial condition. If we issue equity securities, substantial dilution to existing stockholders may result.

We may elect to purchase or otherwise retire the remaining $10.2 million face value of Allied Riser notes with cash, stock or assets from time to time in open market or privately negotiated transactions, either directly or through intermediaries where we believe that market conditions are favorable to do so. Such purchases may have a material effect on our liquidity, financial condition and results of operations.

Off-Balance Sheet Arrangements

We do not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. In addition, we do not engage in trading activities involving non-exchange traded contracts. As such, we are not materially exposed to any financing, liquidity, market or credit risk that could arise if we had engaged in these relationships.

Critical Accounting Policies and Significant Estimates

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses, and the related disclosure of contingent assets and liabilities. On an on-going basis, we evaluate our estimates including those related to allowances for doubtful accounts, revenue allowances, long-lived assets, accruals, contingencies and litigation, and the carrying values of assets and liabilities. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

We historically have not experienced significant revisions to our estimates except to the extent that they result from (1) changes in estimated litigation accruals, (2) changes in estimated leased circuit obligations, (3) changes in the number of option renewal periods used in determining the lease term for purposes of determining the amortization period for our leasehold improvements, (4) changes in our estimates of the percentage of time our employees were involved in our construction activities and (5) changes in estimated sub-lease income which has caused us to revise our lease accruals for abandoned facilities.

The accounting policies we believe to be most critical to understanding our financial results and condition and that require complex, significant and subjective management judgments are discussed below.

Revenue Recognition

We recognize service revenue when the services are performed, evidence of an arrangement exists, the fee is fixed and determinable and collection is probable. Service discounts and incentives offered to certain customers are recorded as a reduction of revenue when granted. Fees billed in connection with customer installations are deferred and recognized ratably over the estimated customer life. We determine the

estimated customer life using a historical analysis of customer retention. If our estimated customer life increases, we will recognize installation revenue over a longer period. We expense direct costs associated with sales as incurred.

Allowances for Sales Credits and Unfulfilled Customer Purchase Obligations

We have established allowances to account for sales credits and unfulfilled contractual purchase obligations.

- Our allowance for sales credits is recorded as a reduction to our service revenue to provide for situations when customers are granted a service termination adjustment for amounts billed in advance or a service level agreement credit or discount. This allowance is determined by actual credits granted during the period and an estimate of unprocessed credits.

- Our allowance for unfulfilled contractual customer purchase obligations is designed to account for the possible non-payment of amounts under agreements that we have with certain of our customers that place minimum purchase obligations on them. Although we vigorously seek payments due pursuant to these purchase obligations, we have historically collected only a small portion of these billed obligations. In order to allow for this, we reduce our gross service revenue by the amount that has been invoiced to these customers. We reduce this allowance and recognize the related service revenue only upon the receipt of cash payments in respect of these invoices. This allowance is determined by the amount of unfulfilled contractual purchase obligations invoiced to our customers and with respect to which we are continuing to seek payment.

Valuation Allowances for Doubtful Accounts Receivable and Deferred Tax Assets

We have established allowances associated with uncollectible accounts receivable and our deferred tax assets.

- Our valuation allowance for uncollectible accounts receivable is designed to account for the expense associated with accounts receivable that we estimate will not be collected. We assess the adequacy of this allowance by evaluating general factors, such as the length of time individual receivables are past due, historical collection experience, and changes in the credit-worthiness of our customers. We also assess the ability of specific customers to meet their financial obligations to us and establish specific allowances based on the amount we expect to collect from these customers.

- Our valuation allowance for our net deferred tax asset reflects the uncertainty surrounding the realization of our net operating losses and our other deferred tax assets. For federal and state tax purposes, our net operating loss carry-forwards, including those that we have generated through our operations and those acquired in the Allied Riser merger could be subject to significant limitations on annual use. To reflect for this uncertainty and the uncertainty of future taxable income we have recorded a valuation allowance for the full amount of our net deferred tax asset.

Impairment of Long-Lived Assets

We review our long-lived assets, including property and equipment, and intangible assets with definite useful lives for impairment whenever events or changes in circumstances indicate that the carrying amount should be addressed pursuant to the Financial Accounting Standards Board s (FASB) Statement of Financial Accounting Standards (SFAS) No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. Pursuant to SFAS No. 144, impairment is determined by comparing the carrying value of these long-lived assets to our estimate of future undiscounted cash flows expected to result from the use of the assets. In the event that there are changes in the planned use of our long-lived assets, or our expected future undiscounted cash flows are reduced significantly, our assessment of our ability to recover the carrying value of these assets under SFAS No. 144 could change. No impairment pursuant to SFAS No. 144 existed at December 31, 2005 or 2006.

Business Combinations

We account for our business combinations pursuant to SFAS No. 141, *Business Combinations*. Under SFAS No. 141 we allocate the cost of an acquired entity to the assets acquired and liabilities assumed based upon their estimated fair values at the date of acquisition. Intangible assets are recognized when they arise from contractual or other legal rights or if they are separable. We determine estimated fair values using quoted market prices, when available, or by present values of future cash flows discounted at appropriate interest rates. Consideration not in the form of cash is measured based upon the estimated fair value of the consideration given. We amortize our intangible assets on a straight-line basis or using an accelerated method consistent with expected cash flows. We presently have no intangible assets that are not subject to amortization.

Equity-based Compensation

Effective January 1, 2006, we adopted FASB Statement No. 123(R), *Share-Based Payment* (Statement 123(R)), using the modified-prospective-transition method. The adoption of Statement 123(R) requires us to make additional estimates and judgments that affect our financial statements. These estimates include the following which impact the amount of compensation expense recorded under Statement 123(R).

Expected Dividend Yield We have never declared or paid dividends and have no plans to do so in the foreseeable future. Additionally, our credit facility prohibits us from paying cash dividends.

Expected Volatility We use the historical volatility since our June 2005 public offering to estimate expected volatility because less than 3% of our fully diluted shares were publicly traded before that date.

Risk-Free Interest Rate We use the zero coupon U.S. Treasury rate during the quarter having a term that most closely resembles the expected term of the option.

Expected Term of the Option We estimate the expected life of the option term by analyzing historical stock option exercises and other relevant data.

Forfeiture Rates We estimate the forfeiture rate based on historical data with further consideration given to the class of employees to whom the options were granted.

Other Accounting Policies

We record assets and liabilities under capital leases at the lesser of the present value of the aggregate future minimum lease payments or the fair value of the assets under lease.

We capitalize the direct costs incurred prior to an asset being ready for service. These costs include costs under the related construction contract and the salaries and benefits of employees directly involved with construction activities. Our capitalization of these costs is based upon estimates of time for our employees involved in construction activities.

We estimate our litigation accruals based upon our estimate of the expected outcome after consultation with legal counsel.

We estimate our accruals for disputed leased circuit obligations based upon the nature and age of the dispute. Our network costs are impacted by the timing and amounts of disputed circuit costs. We generally record these disputed amounts when billed by the vendor and reverse these amounts when the vendor credit has been received or the dispute has otherwise been resolved.

We estimate the useful lives of our property and equipment based upon historical usage with consideration given to technological changes and trends in the industry that could impact the asset utilization.

We establish the number of renewal option periods used in determining the lease term for amortizing leasehold improvements based upon our assessment at the inception of the lease of the number of option periods that are reasonably assured in accordance with SFAS No. 13 *Accounting for Leases*.

We estimate our restructuring and abandoned lease facilities accruals based upon our estimate of the net present value of cash flows expected from these obligations including expected sub-lease income after consideration of market conditions for these and similar properties and the terms of the related lease agreement.

Recent Accounting Pronouncements

Prior to January 1, 2006, we accounted for our equity-based compensation plans under the recognition and measurement provisions of Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* (Opinion 25), and related Interpretations, as permitted by FASB Statement No. 123, *Accounting for Stock-Based Compensation* (Statement 123). Effective January 1, 2006, we adopted FASB Statement No. 123(R), *Share-Based Payment* (Statement 123(R)), using the modified-prospective transition method. Under the modified-prospective transition method, compensation cost recognized in 2006 includes: (a) compensation cost for all share-based payments granted prior to but not yet vested as of January 1, 2006, based on the grant date fair value, and (b) compensation cost for all share-based payments granted subsequent to January 1, 2006, based on the grant-date fair value. Results for prior periods have not been restated. As a result of adopting Statement 123(R), our net loss for the year ended December 31, 2006, was approximately $0.7 million greater than if it had continued to account for share-based compensation under Opinion 25. Upon the adoption of Statement 123(R), $9.7 million of deferred compensation was offset against additional paid-in-capital.

In June 2006, the FASB issued FIN No. 48, *Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement No. 109*. FIN No. 48 requires that management determine whether a tax position is more likely than not to be sustained upon examination, including resolution of any related appeals or litigation processes, based on the technical merits of the position. Once it is determined that a position meets this recognition threshold, the position is measured to determine the amount of benefit to be recognized in the financial statements. We will adopt the provisions of FIN No. 48 beginning in the first quarter of 2007. We are currently evaluating the effect, if any, the adoption of FIN No. 48 will have on our financial statements. Based upon our analysis performed to date, we do not believe that the adoption of FIN No. 48 will have a material effect on our financial position.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Interest income and expense are sensitive to changes in the general level of interest rates. However, based upon the nature and current level of our investments, which are primarily cash and cash equivalents, we believe that there is no material risk of interest rate exposure.

Our European and Canadian operations expose us to currency fluctuations and exchange rate risk. For example, while we record financial results from our European and Canadian operations in euros and the Canadian dollar, respectively, these results are reflected in our consolidated financial statements in U.S. dollars. The assets and liabilities associated with our European and Canadian operations are translated into U.S. dollars and reflected in our consolidated financial statements in U.S. dollars. Therefore, our reported results are exposed to fluctuations in the exchange rates between the U.S. dollar and the euro and the Canadian dollar. In addition, we fund the euro-based operating expenses and associated cash flow requirements of our European operations, including IRU obligations, in U.S. dollars. Accordingly, in the event that the euro strengthens versus the dollar to a greater extent, the expenses and cash flow requirements associated with our European operations may be significantly higher in U.S.-dollar terms than planned.

ITEM 8. INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

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Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders of Cogent Communications Group, Inc.

We have audited the accompanying consolidated balance sheets of Cogent Communications Group, Inc. and subsidiaries (the Company) as of December 31, 2005 and 2006, and the related consolidated statements of operations, changes in stockholders equity, and cash flows for each of the three years in the period ended December 31, 2006. Our audits also included the financial statement schedule listed in the index at Item 15(a)2. These financial statements and schedule are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Cogent Communications Group, Inc. and subsidiaries at December 31, 2005 and 2006, and the consolidated results of their operations and their cash flows for the each of the three years in the period ended December 31, 2006, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

As discussed in Note 1 to the consolidated financial statements, in 2006, the Company adopted Statement of Financial Accounting Standards No. 123(R), Share Based Payment.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Cogent Communications Group, Inc. and subsidiaries internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 13, 2007 expressed an unqualified opinion thereon.

/s/ ERNST & YOUNG LLP

McLean, VA
March 13, 2007

COGENT COMMUNICATIONS GROUP, INC., AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

AS OF DECEMBER 31, 2005 AND 2006
(IN THOUSANDS, EXCEPT SHARE AND PER SHARE DATA)

	2005	2006
Assets		
Current assets:		
Cash and cash equivalents	$ 29,883	$ 42,642
Short term investments ($1,283 and $0 restricted, respectively)	1,283	80
Accounts receivable, net of allowance for doubtful accounts of $1,437 and $1,233, respectively	16,452	20,053
Prepaid expenses and other current assets	3,959	5,339
Total current assets	51,577	68,114
Property and equipment:		
Property and equipment	488,142	512,321
Accumulated depreciation and amortization	(195,355)	(249,053)
Total property and equipment, net	292,787	263,268
Intangible assets, net	2,554	1,150
Deposits and other assets ($1,118 restricted)	4,455	4,344
Total assets	$ 351,373	$ 336,876
Liabilities and stockholders equity		
Current liabilities:		
Accounts payable	$ 11,521	$ 9,096
Accrued liabilities	16,275	12,614
Convertible subordinated notes, net of discount of $1,213 due June 2007		8,978
Current maturities, capital lease obligations	6,698	6,027
Total current liabilities	34,494	36,715
Capital lease obligations, net of current maturities	85,694	82,019
Convertible subordinated notes, net of discount of $3,478	6,713	
Other long term liabilities	3,471	2,510
Total liabilities	130,372	121,244
Commitments and contingencies:		
Stockholders equity:		
Common stock, $0.001 par value; 75,000,000 shares authorized; 44,092,652 and 48,928,108 shares issued and outstanding, respectively	44	49
Additional paid-in capital	440,500	478,140
Deferred compensation	(9,680)	
Stock purchase warrants	764	764
Treasury stock, 61,462 and no shares, respectively	(90)	
Accumulated other comprehensive income foreign currency translation adjustment	665	1,638
Accumulated deficit	(211,202)	(264,959)
Total stockholders equity	221,001	215,632
Total liabilities and stockholders equity	$ 351,373	$ 336,876

The accompanying notes are an integral part of these consolidated balance sheets.

COGENT COMMUNICATIONS GROUP, INC., AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS

FOR THE YEARS ENDED DECEMBER 31, 2004, DECEMBER 31, 2005 AND DECEMBER 31, 2006
(IN THOUSANDS EXCEPT SHARE AND PER SHARE DATA)

	2004	2005	2006
Service revenue, net	$ 91,286	$ 135,213	$ 149,071
Operating expenses:			
Network operations (including $858, $399 and $315 of equity-based compensation expense, respectively, exclusive of amounts shown separately)	64,324	86,193	80,421
Selling, general, and administrative (including $11,404, $12,906 and $10,194 of equity-based compensation expense, and $3,995, $4,574 and $2,584 of bad debt expense, respectively)	51,786	54,250	56,787
Restructuring charges	1,821	1,319	
Terminated public offering costs	779		
Depreciation and amortization	56,645	55,600	58,414
Total operating expenses	175,355	197,362	195,622
Operating loss	(84,069)	(62,149)	(46,551)
Gain Cisco credit facility		842	
Gains capital lease obligation restructurings	5,292	844	255
Gains disposition of assets		3,372	254
Interest income and other	2,119	1,320	2,969
Interest expense	(13,002)	(11,747)	(10,684)
Net loss	$ (89,660)	$ (67,518)	$ (53,757)
Beneficial conversion charges	(43,986)		
Net loss available to common shareholders	$ (133,646)	$ (67,518)	$ (53,757)
Net loss per common share:			
Basic and diluted net loss per common share	$ (117.43)	$ (1.96)	$ (1.16)
Beneficial conversion charge	$ (57.61)	$	$
Basic and diluted net loss per common share available to common shareholders	$ (175.03)	$ (1.96)	$ (1.16)
Weighted-average common shares basic and diluted	763,540	34,439,937	46,343,372

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

COGENT COMMUNICATIONS GROUP, INC., AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY
FOR THE YEARS ENDED DECEMBER 31, 2004 DECEMBER 31, 2005 AND DECEMBER 31, 2006
(IN THOUSANDS, EXCEPT SHARE AMOUNTS)

	Common Stock Shares	Amount	Additional Paid-in Capital	Deferred Compensation	Treasury Stock	Stock Purchase Warrants	Preferred Stock F Shares	Amount	Preferred Stock G Shares	Amount	Preferred Stock H Shares	Amount	Preferred Stock I Shares	Amount
Balance at December 31, 2003	**653,567**	$	**$ 232,475**	**$ (32,680)**	**$ (90)**	**$ 764**	**11,000**	**$ 10,904**	**$ 41,030**	**$ 40,787**	**53,373**	**$ 45,990**		$
Total, December 31, 2003														
Forfeitures of shares granted to employees				4,966							(5,127)	(4,965)		
Equity-based compensation expense				12,262										
Foreign currency translation														
Issuances of preferred stock, net				(2,370)							1,913	2,370	2,575	2,545
Issuances of options for preferred stock				(4,711)								4,711		
Conversion of preferred stock into common stock	173,920		3,808						(9)	(9)	(4,338)	(3,797)		
Beneficial conversion charge			43,896											
Reclassification of beneficial conversion charge to additional paid in capital			(43,896)											
Contribution of capital LNG related party			410											
Net loss														
Balance at December 31, 2004	**827,487**	**1**	**236,692**	**(22,533)**	**(90)**	**764**	**11,000**	**10,904**	**41,021**	**40,778**	**45,821**	**44,309**	**2,575**	**2,545**
Total, December 31, 2004														
Forfeitures of shares granted to employees	(23,069)		(686)	697							(14)	(11)		
Equity-based compensation expense				13,306										
Foreign currency translation														
Issuances of common stock, net	11,719,231	11	64,712	(1,150)										
Conversion of preferred stock into common stock	31,569,003	32	139,782				(11,000)	(10,904)	(41,021)	(40,778)	(45,807)	(44,298)	(2,575)	(2,545)
Net loss														
Balance at December 31, 2005	**44,092,652**	**44**	**440,500**	**(9,680)**	**(90)**	**764**								
Total, December 31, 2005														
Forfeitures of shares granted to employees	(646)													
Adoption of SFAS 123(R) reclassification of deferred compensation			(9,680)	9,680										
Equity-based compensation expense			10,509											
Foreign currency translation														
Issuances of common stock, net	4,732,500	5	36,474											

Exercises of options for common stock	103,602		427								
Treasury stock retirement			(90)		90						
Net loss											
Balance at December 31, 2006	**48,928,108**	**$ 49**	**$ 478,140**	**$**	**$**	**$ 764**	**$**	**$**	**$**	$	
Total, December 31, 2006											

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

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COGENT COMMUNICATIONS GROUP, INC., AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY (Continued)
FOR THE YEARS ENDED DECEMBER 31, 2004 DECEMBER 31, 2005 AND DECEMBER 31, 2006
(IN THOUSANDS, EXCEPT SHARE AMOUNTS)

rred J es	Amount	Preferred Stock K Shares	Amount	Preferred Stock L Shares	Amount	Preferred Stock M Shares	Amount	Foreign Currency Translation Adjustment	Accumulated Deficit	T S E
	$		**$**		**$**		**$**	**$ 628**	**$ (54,024)**	**$**
								887		8
	19,421	2,600	2,588	185	927					2
						3,701	18,353			1
									(43,896)	
									43,896	

 uch prior written consent shall be null and void; *provided*, *however*, that Parent or Merger Sub may assign this Agreement to any Affiliate of Parent without the prior consent of the Company; *provided further*, that no assignment shall limit the assignor s obligations hereunder (including in connection with any such assignment by Parent and including those transactions specifically contemplated by Section 2.7 and 2.9 hereof, which shall in no way be effected by any such assignment by Parent). Subject to the preceding sentence, this Agreement will be binding upon, inure to the benefit of, and be enforceable by, the parties and their respective successors and assigns.

Section 10.12 *Enforcement*. The parties agree that irreparable damage would occur in the event that any of the provisions of this Agreement were not performed in accordance with their specific terms or were otherwise breached. Accordingly, each of the parties shall be entitled to specific performance of the terms hereof, including an injunction or injunctions to prevent breaches of this Agreement and to enforce specifically the terms and

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provisions of this Agreement in any Washington State or federal court sitting in King County (or, if such court lacks subject matter jurisdiction, in any appropriate Washington State or federal court), this being in addition to any other remedy to which such party is entitled at law or in equity. Each of the parties hereby further waives (a) any defense in any action for specific performance that a remedy at law would be adequate and (b) any requirement under any law to post security as a prerequisite to obtaining equitable relief.

Section 10.13 *Currency*. All references to dollars or $ or US$ in this Agreement or any Operative Document refer to United States dollars, which is the currency used for all purposes in this Agreement and any Operative Document.

Section 10.14 *Severability*. Whenever possible, each provision or portion of any provision of this Agreement shall be interpreted in such manner as to be effective and valid under applicable Law, but if any provision or portion of any provision of this Agreement is held to be invalid, illegal or unenforceable in any respect under any applicable Law or rule in any jurisdiction, such invalidity, illegality or unenforceability shall not affect any other provision or portion of any provision in such jurisdiction, and this Agreement shall be reformed, construed and enforced in such jurisdiction as if such invalid, illegal or unenforceable provision or portion of any provision had never been contained herein.

Section 10.15 *Waiver of Jury Trial*. EACH OF THE PARTIES TO THIS AGREEMENT HEREBY IRREVOCABLY WAIVES ALL RIGHT TO A TRIAL BY JURY IN ANY ACTION, PROCEEDING OR COUNTERCLAIM ARISING OUT OF OR RELATING TO THIS AGREEMENT OR THE TRANSACTIONS CONTEMPLATED HEREBY.

Section 10.16 *Counterparts*. This Agreement may be executed in two or more counterparts, all of which shall be considered one and the same instrument and shall become effective when one or more counterparts have been signed by each of the parties and delivered to the other party.

Section 10.17 *Facsimile Signature*. This Agreement may be executed by facsimile signature and a facsimile signature shall constitute an original for all purposes.

Section 10.18 *Time of Essence*. Time is of the essence with regard to all dates and time periods set forth or referred to in this Agreement.

Section 10.19 *No Presumption Against Drafting Party*. Each of Parent, Merger Sub and the Company acknowledges that each party to this Agreement has been represented by counsel in connection with this Agreement and the transactions contemplated by this Agreement. Accordingly, any rule of law or any legal decision that would require interpretation of any claimed ambiguities in this Agreement against the drafting party has no application and is expressly waived.

[The remainder of this page is intentionally left blank.]

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IN WITNESS WHEREOF, the parties have caused this Agreement to be executed as of the date first written above by their respective officers thereunto duly authorized.

AMAZON.COM, INC.

By: /s/ PETER KRAWIEC
Name: **Peter Krawiec**
Title: **Vice President**

ZETA ACQUISITION, INC.

By: /s/ PETER KRAWIEC
Name: **Peter Krawiec**
Title: **Vice President**

ZAPPOS.COM, INC.

By: /s/ ALFRED LIN
Name: **Alfred Lin**
Title: **Chairman, COO/CFO**

SHAREHOLDER REPRESENTATIVE

By: /s/ ALFRED LIN
Name: **Alfred Lin**

[*Signature Page to Agreement and Plan of Merger*]

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APPENDIX B

CHAPTER 13 OF THE CALIFORNIA GENERAL CORPORATION LAW

Chapter 13. Dissenters Rights

§ 1300. Right to Require Purchase Dissenting Shares and Dissenting Shareholder Defined.

(a) If the approval of the outstanding shares (Section 152) of a corporation is required for a reorganization under subdivisions (a) and (b) or subdivision (e) or (f) of Section 1201, each shareholder of the corporation entitled to vote on the transaction and each shareholder of a subsidiary corporation in a short-form merger may, by complying with this chapter, require the corporation in which the shareholder holds shares to purchase for cash at their fair market value the shares owned by the shareholder which are dissenting shares as defined in subdivision (b). The fair market value shall be determined as of the day before the first announcement of the terms of the proposed reorganization or short-form merger, excluding any appreciation or depreciation in consequence of the proposed action, but adjusted for any stock split, reverse stock split, or share dividend which becomes effective thereafter.

(b) As used in this chapter, dissenting shares means shares which come within all of the following descriptions:

(1) Which were not immediately prior to the reorganization or short-form merger either (A) listed on any national securities exchange certified by the Commissioner of Corporations under subdivision (o) of Section 25100 or (B) listed on the National Market System of the NASDAQ Stock Market, and the notice of meeting of shareholders to act upon the reorganization summarizes this section and Sections 1301, 1302, 1303 and 1304; provided, however, that this provision does not apply to any shares with respect to which there exists any restriction on transfer imposed by the corporation or by any law or regulation; and provided, further, that this provision does not apply to any class of shares described in subparagraph (A) or (B) if demands for payment are filed with respect to 5 percent or more of the outstanding shares of that class.

(2) Which were outstanding on the date for the determination of shareholders entitled to vote on the reorganization and (A) were not voted in favor of the reorganization or, (B) if described in subparagraph (A) or (B) of paragraph (1) (without regard to the provisos in that paragraph), were voted against the reorganization, or which were held of record on the effective date of a short-form merger; provided, however, that subparagraph (A) rather than subparagraph (B) of this paragraph applies in any case where the approval required by Section 1201 is sought by written consent rather than at a meeting.

(3) Which the dissenting shareholder has demanded that the corporation purchase at their fair market value, in accordance with Section 1301.

(4) Which the dissenting shareholder has submitted for endorsement, in accordance with Section 1302.

(c) As used in this chapter, dissenting shareholder means the recordholder of dissenting shares and includes a transferee of record.

§ 1301. Demand for Purchase.

(a) If, in the case of a reorganization, any shareholders of a corporation have a right under Section 1300, subject to compliance with paragraphs (3) and (4) of subdivision

(b) thereof, to require the corporation to purchase their shares for cash, that corporation shall mail to each such shareholder a notice of the approval of the reorganization by its outstanding shares (Section 152) within 10 days after the date of that approval, accompanied by a copy of Sections 1300, 1302, 1303 and 1304 and this section, a statement of the price determined by the corporation to represent the fair market value of the dissenting shares, and a brief description of the procedure to be followed if the shareholder desires to exercise the shareholder s right under those sections. The statement of price constitutes an offer by the corporation to purchase at the price stated any dissenting shares as defined in subdivision (b) of Section 1300, unless they lose their status as dissenting shares under Section 1309.

(b) Any shareholder who has a right to require the corporation to purchase the shareholder s shares for cash under Section 1300, subject to compliance with paragraphs (3) and (4) of subdivision (b) thereof, and who desires the corporation to purchase shares shall make written demand upon the corporation for the purchase of those shares and payment to the shareholder in cash of their fair market value. The demand is not effective for any purpose unless it is received by the corporation or any transfer agent thereof (1) in the case of shares described in clause (A) or (B) of paragraph (1) of subdivision (b) of Section 1300 (without regard to the provisos in that paragraph), not later than the date of the shareholders meeting to vote upon the reorganization, or (2) in any other case within 30 days after the date on which the notice of the approval by the outstanding shares pursuant to subdivision (a) or the notice pursuant to subdivision (i) of Section 1110 was mailed to the shareholder.

(c) The demand shall state the number and class of the shares held of record by the shareholder which the shareholder demands that the corporation purchase and shall contain a statement of what that shareholder claims to be the fair market value of those shares as of the day before the announcement of the proposed reorganization or short-form merger. The statement of fair market value constitutes an offer by the shareholder to sell the shares at that price.

§ 1302. Endorsement of Shares.

Within 30 days after the date on which notice of the approval by the outstanding shares or the notice pursuant to subdivision (i) of Section 1110 was mailed to the shareholder, the shareholder shall submit to the corporation at its principal office or at the office of any transfer agent thereof, (a) if the shares are certificated securities, the shareholder s certificates representing any shares which the shareholder demands that the corporation purchase, to be stamped or endorsed with a statement that the shares are dissenting shares or to be exchanged for certificates of appropriate denomination so stamped or endorsed or (b) if the shares are uncertificated securities, written notice of the number of shares which the shareholder demands that the corporation purchase. Upon subsequent transfers of the dissenting shares on the books of the corporation, the new certificates, initial transaction statement, and other written statements issued therefor shall bear a like statement, together with the name of the original dissenting holder of the shares.

§ 1303. Agreed Price Time for Payment.

(a) If the corporation and the shareholder agree that the shares are dissenting shares and agree upon the price of the shares, the dissenting shareholder is entitled to the agreed price with interest thereon at the legal rate on judgments from the date of the agreement. Any agreements fixing the fair market value of any dissenting shares as between the corporation and the holders thereof shall be filed with the secretary of the corporation.

(b) Subject to the provisions of Section 1306, payment of the fair market value of dissenting shares shall be made within 30 days after the amount thereof has been agreed or within 30 days after any statutory or contractual conditions to the reorganization are satisfied, whichever is later, and in the case of certificated securities, subject to surrender of the certificates therefor, unless provided otherwise by agreement.

§ 1304. Dissenter s Action to Enforce Payment.

(a) If the corporation denies that the shares are dissenting shares, or the corporation and the shareholder fail to agree upon the fair market value of the shares, then the shareholder demanding purchase of such shares as dissenting shares or any interested corporation, within six months after the date on which notice of the approval by the outstanding shares (Section 152) or notice pursuant to subdivision (i) of Section 1110 was mailed to the shareholder, but not thereafter, may file a complaint in the superior

court of the proper county praying the court to determine whether the shares are dissenting shares or the fair market value of the dissenting shares or both or may intervene in any action pending on such a complaint.

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(b) Two or more dissenting shareholders may join as plaintiffs or be joined as defendants in any such action and two or more such actions may be consolidated.

(c) On the trial of the action, the court shall determine the issues. If the status of the shares as dissenting shares is in issue, the court shall first determine that issue. If the fair market value of the dissenting shares is in issue, the court shall determine, or shall appoint one or more impartial appraisers to determine, the fair market value of the shares.

§ 1305. Appraisers Report Payment Costs.

(a) If the court appoints an appraiser or appraisers, they shall proceed forthwith to determine the fair market value per share. Within the time fixed by the court, the appraisers, or a majority of them, shall make and file a report in the office of the clerk of the court. Thereupon, on the motion of any party, the report shall be submitted to the court and considered on such evidence as the court considers relevant. If the court finds the report reasonable, the court may confirm it.

(b) If a majority of the appraisers appointed fail to make and file a report within 10 days from the date of their appointment or within such further time as may be allowed by the court or the report is not confirmed by the court, the court shall determine the fair market value of the dissenting shares.

(c) Subject to the provisions of Section 1306, judgment shall be rendered against the corporation for payment of an amount equal to the fair market value of each dissenting share multiplied by the number of dissenting shares which any dissenting shareholder who is a party, or who has intervened, is entitled to require the corporation to purchase, with interest thereon at the legal rate from the date on which judgment was entered.

(d) Any such judgment shall be payable forthwith with respect to uncertificated securities and, with respect to certificated securities, only upon the endorsement and delivery to the corporation of the certificates for the shares described in the judgment. Any party may appeal from the judgment.

(e) The costs of the action, including reasonable compensation to the appraisers to be fixed by the court, shall be assessed or apportioned as the court considers equitable, but, if the appraisal exceeds the price offered by the corporation, the corporation shall pay the costs (including in the discretion of the court attorneys fees, fees of expert witnesses and interest at the legal rate on judgments from the date of compliance with Sections 1300, 1301 and 1302 if the value awarded by the court for the shares is more than 125 percent of the price offered by the corporation under subdivision (a) of Section 1301).

§ 1306. Dissenting Shareholder s Status as Creditor.

To the extent that the provisions of Chapter 5 prevent the payment to any holders of dissenting shares of their fair market value, they shall become creditors of the corporation for the amount thereof together with interest at the legal rate on judgments until the date of payment, but subordinate to all other creditors in any liquidation proceeding, such debt to be payable when permissible under the provisions of Chapter 5.

§ 1307. Dividends Paid as Credit Against Payment.

Cash dividends declared and paid by the corporation upon the dissenting shares after the date of approval of the reorganization by the outstanding shares (Section 152) and prior to payment for the shares by the corporation shall be credited against the total amount to be paid by the corporation therefor.

§ 1308. Continuing Rights and Privileges of Dissenting Shareholders.

Except as expressly limited in this chapter, holders of dissenting shares continue to have all the rights and privileges incident to their shares, until the fair market value of their shares is agreed upon or determined. A dissenting shareholder may not withdraw a demand for payment unless the corporation consents thereto.

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§ 1309. Termination of Dissenting Shareholder Status.

Dissenting shares lose their status as dissenting shares and the holders thereof cease to be dissenting shareholders and cease to be entitled to require the corporation to purchase their shares upon the happening of any of the following:

(a) The corporation abandons the reorganization. Upon abandonment of the reorganization, the corporation shall pay on demand to any dissenting shareholder who has initiated proceedings in good faith under this chapter all necessary expenses incurred in such proceedings and reasonable attorneys fees.

(b) The shares are transferred prior to their submission for endorsement in accordance with Section 1302 or are surrendered for conversion into shares of another class in accordance with the articles.

(c) The dissenting shareholder and the corporation do not agree upon the status of the shares as dissenting shares or upon the purchase price of the shares, and neither files a complaint or intervenes in a pending action as provided in Section 1304, within six months after the date on which notice of the approval by the outstanding shares or notice pursuant to subdivision (i) of Section 1110 was mailed to the shareholder.

(d) The dissenting shareholder, with the consent of the corporation, withdraws the shareholder s demand for purchase of the dissenting shares.

§ 1310. Suspension of Proceedings for Payment Pending Litigation.

If litigation is instituted to test the sufficiency or regularity of the votes of the shareholders in authorizing a reorganization, any proceedings under Sections 1304 and 1305 shall be suspended until final determination of such litigation.

§ 1311. Exempt Shares.

This chapter, except Section 1312, does not apply to classes of shares whose terms and provisions specifically set forth the amount to be paid in respect to such shares in the event of a reorganization or merger.

§ 1312. Attacking Validity of Reorganization or Merger.

(a) No shareholder of a corporation who has a right under this chapter to demand payment of cash for the shares held by the shareholder shall have any right at law or in equity to attack the validity of the reorganization or short-form merger, or to have the reorganization or short-form merger set aside or rescinded, except in an action to test whether the number of shares required to authorize or approve the reorganization have been legally voted in favor thereof; but any holder of shares of a class whose terms and provisions specifically set forth the amount to be paid in respect to them in the event of a reorganization or short-form merger is entitled to payment in accordance with those terms and provisions or, if the principal terms of the reorganization are approved pursuant to subdivision (b) of Section 1202, is entitled to payment in accordance with the terms and provisions of the approved reorganization.

(b) If one of the parties to a reorganization or short-form merger is directly or indirectly controlled by, or under common control with, another party to the reorganization or short-form merger, subdivision (a) shall not apply to any shareholder of such party who has not demanded payment of cash for such shareholder s shares pursuant to this chapter; but if the shareholder institutes any action to attack the validity of the reorganization or short-form merger or to have the reorganization or short-form merger set aside or

rescinded, the shareholder shall not thereafter have any right to demand payment of cash for the shareholder s shares pursuant to this chapter. The court in any action attacking the validity of the reorganization or short-form merger or to have the reorganization or short-form merger set aside or rescinded shall not restrain or enjoin the consummation of the transaction except upon 10 days prior notice to the corporation and upon a determination by the court that clearly no other remedy will adequately protect the complaining shareholder or the class of shareholders of which such shareholder is a member.

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(c) If one of the parties to a reorganization or short-form merger is directly or indirectly controlled by, or under common control with, another party to the reorganization or short-form merger, in any action to attack the validity of the reorganization or short-form merger or to have the reorganization or short-form merger set aside or rescinded, (1) a party to a reorganization or short-form merger which controls another party to the reorganization or short-form merger shall have the burden of proving that the transaction is just and reasonable as to the shareholders of the controlled party, and (2) a person who controls two or more parties to a reorganization shall have the burden of proving that the transaction is just and reasonable as to the shareholders of any party so controlled.

§ 1313. Conversion Deemed to Constitute Reorganization for Purposes of Chapter.

A conversion pursuant to Chapter 11.5 (commencing with Section 1150) shall be deemed to constitute a reorganization for purposes of applying the provisions of this chapter, in accordance with and to the extent provided in Section 1159.

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APPENDIX C

OPINION OF MORGAN STANLEY & CO. INCORPORATED

July 22, 2009

Board of Directors

Zappos.com, Inc.

2280 Corporate Circle Drive

Henderson, Nevada 89074

Members of the Board:

We understand that Zappos.com, Inc. (the Company), Amazon.com, Inc. (the Buyer), Zappos Acquisition, Inc., a wholly owned subsidiary of the Buyer (Acquisition Sub) and Alfred Lin solely in his capacity as initial shareholder representative, propose to enter into an Agreement and Plan of Merger, substantially in the form of the draft dated July 21, 2009 (the Merger Agreement), which provides, among other things, for the merger (the Merger) of Acquisition Sub with and into the Company. Pursuant to the Merger, the Company will become a wholly owned subsidiary of the Buyer, and all of the outstanding shares of (i) the Series A Preferred Stock, par value $0.001 per share (the Series A Preferred Stock), (ii) the Series B Preferred Stock, par value $0.001 per share (the Series B Preferred Stock), (iii) the Series C Preferred Stock, par value $0.001 per share (the Series C Preferred Stock), (iv) the Series D Preferred Stock, par value $0.001 per share (the Series D Preferred Stock), (v) the Series E Preferred Stock, par value $0.001 per share (the Series E Preferred Stock), (vi) the Series F Preferred Stock, par value $0.001 per share (the Series F Preferred Stock and together with the Series A Preferred Stock, the Series B Preferred Stock, the Series C Preferred Stock, the Series D Preferred Stock and the Series E Preferred Stock, the Company Preferred Stock) and (vi) common stock, par value $0.001 per share (the Company Common Stock and, together with the Company Preferred Stock, the Company Stock) of the Company, other than shares held in treasury or owned, directly or indirectly by the Company, or any of its Subsidiaries (as defined in the Merger Agreement), the Buyer or Acquisition Sub, or as to which dissenters rights have been perfected, will be converted into the right to receive common stock, par value $0.01 per share, of the Buyer (the Buyer Common Stock) on the terms and conditions set forth in the Merger Agreement (the Consideration). The other terms and conditions of the Merger are more fully set forth in the Merger Agreement.

You have asked for our opinion as to whether the Consideration to be received by the holders of shares of the Company Stock pursuant to the Merger Agreement is fair from a financial point of view to such holders, taken as a whole.

For purposes of the opinion set forth herein, we have:

1) Reviewed certain internal financial statements and other financial and operating data concerning the Company;

2)

Reviewed certain financial projections for the Company prepared by the management of the Company;

3) Reviewed certain publicly available financial statements and other business and financial information of the Buyer, and certain publicly available financial projections for the Buyer prepared by research analysts;

4) Discussed the past and current operations and financial condition and the prospects of the Company, including information relating to certain strategic, financial and operational benefits anticipated from the Merger, with senior executives of the Company;

5) Discussed the past and current operations and financial condition and the prospects of the Buyer, with senior executives of the Buyer;

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6) Reviewed the reported prices and trading activity for the Buyer Common Stock;

7) Compared the financial performance of the Company and the Buyer and the prices and trading activity of the Buyer Common Stock with that of certain other publicly-traded companies comparable to the Company and the Buyer, respectively;

8) Reviewed the financial terms, to the extent publicly available, of certain comparable acquisition transactions;

9) Participated in discussions and negotiations among representatives of the Company and the Buyer and their financial and legal advisors;

10) Reviewed the Merger Agreement and certain related documents; and

11) Performed such other analyses and considered such other factors as we have deemed appropriate.

We have assumed and relied upon, without independent verification, the accuracy and completeness of the information that was publicly available or supplied or otherwise made available to us by the Company and the Buyer and formed a substantial basis for this opinion. With respect to the Company s financial projections, we have assumed that they have been reasonably prepared on bases reflecting the best currently available estimates and judgments of the management of the Company of the future financial performance of the Company. We have relied upon, without independent verification, the assessment by the managements of the Company and the Buyer of: (i) the timing and risks associated with the integration of the Company and the Buyer; (ii) their ability to retain key employees of the Company and the Buyer, respectively and (iii) the validity of, and risks associated with, the Company and the Buyer s existing and future technologies, intellectual property, products, services and business models. In addition, we have assumed that the Merger will be consummated in accordance with the terms set forth in the Merger Agreement without any waiver, amendment or delay of any terms or conditions, including, among other things, that the Merger will be treated as a tax-free reorganization and/or exchange, each pursuant to the Internal Revenue Code of 1986, as amended. Morgan Stanley has assumed that in connection with the receipt of all the necessary governmental, regulatory or other approvals and consents required for the proposed Merger, no delays, limitations, conditions or restrictions will be imposed that would have a material adverse effect on the contemplated benefits expected to be derived in the proposed Merger. We are not legal, tax, or regulatory advisors. We are financial advisors only and have relied upon, without independent verification, the assessment of the Buyer and the Company and their legal, tax, and regulatory advisors with respect to legal, tax, and regulatory matters. We express no opinion with respect to the fairness of the amount or nature of the compensation to any of the Company s officers, directors or employees, or any class of such persons relative to the consideration to be received by the holders of shares of the Company Stock in the transaction. Morgan Stanley also expresses no opinion as to the fairness of the consideration to be received by shareholders in respect of any particular class or series of Company Stock. We have not made any independent valuation or appraisal of the assets or liabilities of the Company, nor have we been furnished with any such appraisals. Our opinion is necessarily based on financial, economic, market and other conditions as in effect on, and the information made available to us as of, the date hereof. Events occurring after the date hereof may affect this opinion and the assumptions used in preparing it, and we do not assume any obligation to update, revise or reaffirm this opinion.

In arriving at our opinion, we were not authorized to solicit, and did not solicit, interest from any party with respect to an acquisition, business combination or other extraordinary transaction, involving the Company.

We have acted as financial advisor to the Board of Directors of the Company in connection with this transaction and will receive a fee for our services, a significant portion of which is contingent upon the closing of the Merger. Morgan Stanley may also seek to provide such services to the Buyer in the future and expects to receive fees for the rendering of these services.

Please note that Morgan Stanley is a global financial services firm engaged in the securities, investment management and individual wealth management businesses. Our securities business is engaged in securities underwriting, trading and brokerage activities, foreign exchange, commodities and derivatives trading, prime

brokerage, as well as providing investment banking, financing and financial advisory services. Morgan Stanley, its affiliates, directors and officers may at any time invest on a principal basis or manage funds that invest, hold long or short positions, finance positions, and may trade or otherwise structure and effect transactions, for their own account or the accounts of its customers, in debt or equity securities or loans of the Buyer, the Company, or any other company, or any currency or commodity, that may be involved in this transaction, or any related derivative instrument. As you know, affiliates of Morgan Stanley own approximately 1.6% of the outstanding Company Common Stock on an as-if converted basis.

This opinion has been approved by a committee of Morgan Stanley investment banking and other professionals in accordance with our customary practice. This opinion is for the information of the Board of Directors of the Company and may not be used for any other purpose without our prior written consent. In addition, this opinion does not in any manner address the prices at which the Buyer Common Stock will trade following announcement or consummation of the Merger and Morgan Stanley expresses no opinion or recommendation as to how the shareholders of the Company should vote in connection with the Merger.

Based on and subject to the foregoing, we are of the opinion on the date hereof that the Consideration to be received by the holders of shares of the Company Stock pursuant to the Merger Agreement is fair from a financial point of view to such holders, taken as a whole.

Very truly yours,

MORGAN STANLEY & CO. INCORPORATED

By: /s/ CYNTHIA GAYLOR
Cynthia Gaylor

Executive Director

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APPENDIX D

CONSOLIDATED FINANCIAL STATEMENTS (AUDITED)

Zappos.com, Inc.

Years ended December 31, 2008 and 2007

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Report of Independent Accountants

To the Board of Directors and Shareholders of Zappos.com, Inc.:

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of operations, stockholders equity and comprehensive income (loss) and cash flows present fairly, in all material respects, the financial position of Zappos.com (the Company) and its subsidiaries at December 31, 2008 and December 31, 2007, and the results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 2 to the consolidated financial statements, the Company changed the manner in which it accounts for uncertain tax positions in 2007.

/s/ PricewaterhouseCoopers LLP

San Jose, California

March 23, 2009

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ZAPPOS.COM, INC.

CONSOLIDATED BALANCE SHEETS

(in thousands)

	As of	
	December 31, 2008	**December 31, 2007**
Assets		
Current assets:		
Cash and cash equivalents	$ 8,590	$ 6,761
Restricted cash	2,245	1,687
Accounts receivable, net	6,772	8,461
Inventory, net	168,131	161,988
Deferred income taxes	15,890	12,267
Prepaid expenses and other assets	3,253	2,596
Total current assets	204,881	193,760
Property and equipment, net	48,962	44,286
Deferred income taxes	708	3,098
Intangible assets, net	8,646	4,405
Other assets, net	2,075	705
Total assets	$ 265,272	$ 246,254
Liabilities and stockholders equity		
Current liabilities:		
Accounts payable	$ 69,792	$ 76,055
Accrued and other liabilities	51,409	28,467
Deferred income taxes	559	527
Accrued sales returns	18,637	16,762
Current portion of loan obligations	4,863	2,747
Current portion of capital lease obligations	1,490	1,051
Revolving line of credit	26,006	29,000
Total current liabilities	172,756	154,609
Deferred rent	1,514	1,883
Deferred income taxes	2,870	3,418
Other long term liabilities	19,935	28,868
Loan obligations, noncurrent	15,777	20,188
Capital lease obligations, noncurrent	1,702	1,809
Total liabilities	214,554	210,775
Stockholders equity:		
Convertible preferred stock; $0.001 par value; 35,997 authorized, 29,248, and 29,285 issued and outstanding (aggregate liquidation preference $181,466 and $181,469)	61,465	61,465
Common stock; $0.001 par value; 60,000 authorized, 15,916 and 14,260 issued and outstanding	16	14
Additional paid-in capital	6,557	2,092
Accumulated deficit	(17,320)	(28,092)

Total stockholders equity	50,718	35,479
Total liabilities and stockholders equity	$ 265,272	$ 246,254

See accompanying notes to consolidated financial statements

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ZAPPOS.COM, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands)

	For the twelve months ended December 31,	
	2008	**2007**
Net revenues	$ 635,011	$ 526,829
Cost of revenues	411,650	333,884
Gross profit	223,361	192,945
Operating expenses:		
Sales, marketing and fulfillment	153,285	123,260
General and administrative	23,041	18,962
Product development	25,262	18,224
Total operating expenses	201,588	160,446
Income from operations	21,773	32,499
Interest and other income, net	559	731
Interest benefit (expense) associated with preferred stock warrant	9,670	(10,825)
Other interest expense	(5,825)	(6,930)
Other financing charges	(832)	(335)
Income before provision for income taxes	25,345	15,140
Provision for income taxes	(5,208)	(10,288)
Net income from continuing operations	$ 20,137	$ 4,852
Discontinued operations, net of tax	(9,365)	(3,084)
Net income	$ 10,772	$ 1,768

See accompanying notes to consolidated financial statements

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ZAPPOS.COM, INC.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY AND COMPREHENSIVE INCOME

(in thousands)

	Convertible Preferred Stock		Common Stock		Additional Paid-in Capital	Accumulated Other Comprehensive Income	Accumulated Deficit	Total Stockholders Equity
	Shares	Amount	Shares	Amount				
Balance at January 1, 2007	29,285	$ 61,465	14,089	$ 14	$ 745	$ 124	$ (27,657)	$ 34,691
Net income							1,768	1,768
Net unrealized holding gains on derivative instruments, net of tax						(124)		(124)
Comprehensive income								1,644
Exercise of stock options			671	1	203			204
Repurchase and retirement of stock			(500)	(1)	(1,296)		(1,703)	(3,000)
Income tax benefit on stock awards					443			443
Cumulative effect of the adoption of FIN No. 48							(500)	(500)
Stock-based compensation					1,997			1,997
Balance at December 31, 2007	29,285	$ 61,465	14,260	$ 14	$ 2,092	$	$ (28,092)	$ 35,479
Net income							10,772	10,772
Exercise of stock options			1,727	2	1,682			1,684
Vested options cancelled through exchange			(108)		(1,402)			(1,402)
Income tax benefit on stock awards					1,301			1,301
Conversion of preferred stock	(37)		37					
					2,884			2,884

Stock-based compensation								
Balance at December 31, 2008	29,248	$ 61,465	15,916	$ 16	$ 6,557	$	$ (17,320)	$ 50,718

See accompanying notes to consolidated financial statements

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ZAPPOS.COM, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

	For the twelve months ended December 31, 2008	2007
Operating activities		
Net income	$ 10,772	$ 1,768
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of deferred financing costs	309	288
Depreciation and amortization	11,481	9,682
Impairment of fixed assets	638	2,133
Asset retirement obligation	59	62
Reserves on returns	1,875	3,813
Provision for bad and doubtful debt	145	63
Provision for excess and obsolete inventory	2,223	2,985
Stock-based compensation	2,884	1,997
Deferred income taxes	(927)	(2,980)
Cumulative effect of the adoption of FIN 48		(500)
Loss on disposal of property and equipment	6	350
Change in carrying value of preferred stock warrants	(9,670)	10,825
Changes in operating assets and liabilities:		
Credit card and other receivables	1,545	(3,506)
Merchandise inventory	(8,366)	(20,681)
Prepaid expenses and other assets	(2,354)	(1,083)
Accounts payable	(7,443)	16,937
Accrued and other liabilities	22,415	11,494
Net cash provided by operating activities	25,592	33,647
Investing activities		
Purchase of property and equipment	(13,471)	(11,108)
Purchase of intangible assets	(4,850)	
Purchase of 6pm.com intangible assets and inventory		(4,000)
Decrease in restricted cash	404	5,714
Net cash used in investing activities	(17,917)	(9,394)
Financing activities		
Proceeds from exercise of employee stock options	282	204
Repurchase and retirement of stock		(3,000)
Excess tax benefit on stock awards	1,301	443
Increase in restricted cash	(962)	(404)
Borrowings under revolving line of credit	666,333	549,184
Repayment of borrowings under revolving line of credit	(669,327)	(564,965)
Borrowings under loans	271	3,501
Repayment of loan and construction payables	(2,566)	(2,595)
Payment of capital leases	(1,178)	(1,152)
Net cash used in financing activities	(5,846)	(18,784)
Change in cash and cash equivalents	1,829	5,469

Cash and cash equivalents at beginning of year	6,761	1,292
Cash and cash equivalents at end of year	$ 8,590	$ 6,761

See accompanying notes to consolidated financial statements

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ZAPPOS.COM, INC

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 DESCRIPTION OF BUSINESS

Zappos.com, Inc. (Zappos, we, our, or the Company), a California corporation founded in 1999, is an online retailer that sells apparel, shoes, handbags, eyewear, watches, electronics and other products. Among the other value added services we offer our brand partners is our Powered By Zappos program (PBZ), introduced in 2006. Under PBZ, Zappos designs and operates most, if not all aspects of a retailer s website, including fulfillment, returns and customer inquiries. Zappos is the seller of record of all merchandise processed through the PBZ program, yet works closely with the retailer to achieve its desired look and feel.

NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation: The accompanying audited financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America. The accompanying audited consolidated financial statements include the Company and its wholly-owned subsidiaries. All significant intercompany balances and transactions between consolidated entities have been eliminated.

Use of Estimates: The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements, as well as the reported amounts of revenues and expenses during the reporting period. Estimates are used for, but are not limited to, allowances for doubtful accounts, sales returns, in-bound freight, incentive discount offers, inventory valuation, depreciable lives of fixed assets, income taxes, stock-based compensation, valuation of acquired intangible assets, and contingencies. These estimates and assumptions are based on historical information, information that is currently available to management and on various other assumptions that management of the company believes to be reasonable. Actual results could differ materially from those estimates.

Reclassifications: During the fourth quarter of 2008, the Company discontinued operations in its Nevada and Bowling Green, Kentucky retail stores. The results of operations for those stores have been reclassified from the results of operations from continuing operations to discontinued operations, net of tax. For more information regarding the results of discontinued operations, see Note 12. In the third quarter of 2007 the Company changed its process for tracking of expenses within cost centers. As a result of this change, costs associated with certain functional groups have been reclassified to groups deemed to be more representative of the cost incurred. Total operating expense, net income, and stockholder s equity were not affected by this reclassification.

Cash and cash equivalents. We classify as cash equivalents all highly liquid investments with remaining maturities of three months or less when purchased.

Restricted cash includes collections held overnight in transit to Wells Fargo Business Credit, Inc. to pay down our revolving line of credit and amounts in escrow under the terms of the 6pm.com asset purchase.

Fair Value of Financial Instruments and Credit Risk: Financial instruments consist principally of cash and cash equivalents, restricted cash, credit card and other receivables, accounts payables, borrowings under the revolving line of credit, loan

obligations and capital leases. The estimated fair value of these instruments, except for the borrowings under the revolving line of credit, loan obligations and capital leases, approximates their carrying value due to their short-term nature. The carrying value of borrowings under the revolving line of credit approximates its fair value due to the variable interest rate charged under the facility. The fair value of the loan and capital lease obligations approximates their carrying value because they are calculated using the present value of the future cash flow payments.

ZAPPOS.COM, INC

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Financial instruments that subject Zappos to potential risk consist of its cash and cash equivalents, restricted cash, and credit card and other receivables. We manage our risk by maintaining our cash and cash equivalents and restricted cash accounts with highly rated financial institutions. Our credit card and other receivables are substantially derived from credit card purchases from customers, and are typically settled within two to three days. Our exposure to a risk of loss on our credit card and other receivables was approximately $6.8 million and $8.5 million at December 31, 2008 and 2007, respectively.

The Company estimated fair value amounts presented in the consolidated financial statements using available market information and appropriate methodologies. However, considerable judgment is required in interpreting market data to develop the estimates of fair value. The estimates presented herein are not necessarily indicative of the amounts that the Company could realize in a current market exchange. The use of different market assumptions and/or estimation methodologies may have a material effect on the estimated fair value amounts. Such fair value estimates are based on pertinent information available to management as of December 31, 2008, and have not been comprehensively revalued for purposes of these consolidated financial statements since such date.

Merchandise Inventory: Inventories, consisting of products available for sale, are accounted for at the lower of cost or market using the specific identification method. This valuation methodology requires us to make judgments based on currently available information about the likely method of disposition, such as through online sales to individual customers, returns to vendors, or liquidations, and the expected recoverable values of each product through anticipated retail center revenue. Based on such evaluation, we adjust the carrying amount of our inventories to lower of cost or market value. Costs of merchandise inventory include inbound freight costs.

Property and Equipment: Property and equipment are stated at cost, net of accumulated depreciation. Depreciation is provided using the straight-line method over the estimated useful lives of the assets, as follows:

- Three years for office equipment, computer hardware and computer equipment, and automobiles.
- One to three years or license terms for software.
- Three to seven years for furniture and fixtures and machinery and equipment.
- The lesser of 15 years or lease term for leasehold improvements.
- Construction in progress is held on the balance sheet until the project is placed into service. At that time it is depreciated based on its classification.

On retirement or other disposition of property and equipment, the cost and related accumulated depreciation are removed from such asset s account and the resulting gain or loss, if any, is recognized as a gain or loss on disposition of the asset in operating income or loss in our consolidated statements of operations. Expenditures for maintenance and repairs are charged to expense as incurred.

Capitalized Interest: We capitalized interest expense of $0.1 million and $0.1 million during the years ended December 31, 2008 and 2007, respectively. The capitalized interest relates primarily to construction of equipment and fixtures for the fulfillment centers and retail stores in Kentucky and retail stores in Las Vegas and the implementation of new accounting system software. These amounts are included in Property and equipment, net in our consolidated balance sheets and will be depreciated over the useful lives of the related assets once construction is completed.

Internal-Use Software and Website Development: Costs incurred to develop internal-use computer software during the application development stage, including those relating to developing PBZ web sites, are capitalized

ZAPPOS.COM, INC

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

in accordance with AICPA Statement of Position No. 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use* (SOP 98-1). Costs of enhancements to internal-use computer software are also capitalized, provided that such enhancements result in additional functionality.

Derivative Financial Instruments: It is our policy to use derivatives to partially offset our market exposure to fluctuations in interest rates and foreign currencies. During the year ended December 31, 2008, we discontinued our use of foreign currency derivatives. In accordance with Statement of Financial Accounting Standards (SFAS) No. 133, *Accounting for Derivative Instruments and Hedging Activities* (FASB Statement No. 133), Zappos recognizes derivatives on the balance sheet at fair value. The accounting for changes in the fair value of a derivative instrument depends on whether it has been designated and qualifies as part of a hedging relationship and, further, on the type of hedging relationship. None of our derivative financial instruments are accounted for as hedges and, therefore, changes in the fair value of these instruments are recorded in interest and other income and other interest expense. We do not enter into derivatives for speculative or trading purposes.

Deferred Financing Costs: Zappos capitalized deferred financing costs related to fees paid to its lender in connection with its revolving Line of Credit Agreement (see Note 6) and fees paid in connection with additional financing for fulfillment center equipment and fixtures. These fees on the revolving Line of Credit are amortized ratably over the term of the loans. The fees on the loan for fulfillment center equipment and fixtures are amortized using the effective interest method. Deferred financing costs are included in Other financing charges in our consolidated statements of operations. Net short term deferred financing fees of $0.2 million and $0.2 million are included in Prepaid expenses and other assets in our consolidated balance sheets at December 31, 2008 and 2007, respectively. Net long term deferred financing fees of $0.1 million and $0.3 million are included in Other assets in our consolidated balance sheets at December 31, 2008 and 2007, respectively.

Leases: We account for our lease agreements pursuant to FASB Statement No. 13, *Accounting for Leases*, which categorizes leases at their inception as either operating or capital leases depending on certain criteria. On certain of our lease agreements, we may receive rent holidays and other incentives. We recognize lease costs on a straight-line basis without regard to such lease incentives. Additionally, incentives we receive are treated as a reduction of our costs over the term of the agreement.

During 2007, we canceled our purchase option on a leased warehouse in Kentucky in exchange for a $1 million payment from the lessor. The option termination payment was recorded as a deferred rent liability and amortized as a reduction of rent expense over the remaining life of the lease.

Revenue Recognition: Revenue is recognized when the following four revenue recognition criteria are met: (i) persuasive evidence of an arrangement exists, (ii) delivery has occurred or services have been rendered, (iii) the selling price is fixed or determinable, and (iv) collectability is reasonably assured. We recognize revenue, net of estimated returns (calculated based on historical experience and current trends), upon delivery of products to customers which is the point at which risk of loss passes to the customers. Revenue from our retail stores is recognized at the point of sale. Revenue for gift certificates is recognized upon redemption of the gift certificates.

We periodically provide promotions to our customers or employees to encourage purchases or to provide the best customer service possible. Such offers include current discount offers, such as percentage discounts off current purchases. Current discount offers, when accepted by our customers, are treated as a reduction to the selling price of the related transaction. Current discount offers are presented as a net amount in Net revenue in our consolidated statements of operations.

Revenue is recognized on a gross basis in accordance with EITF Issue No. 99-19, Reporting Revenue Gross as a Principal versus net as an Agent because, among other indicators of gross reporting, the Company is

ZAPPOS.COM, INC

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

the primary obligor in its sales arrangements with customers and has general inventory risk before customer orders are placed and upon customer returns. We do not have any drop-ship arrangements with any of our vendors.

Taxes collected from customers that are assessed by taxing authorities are presented on a net basis in accordance with EITF Issue No. 06-3, How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross versus Net Presentation).

Cost of Revenue: Cost of revenue includes the cost of products sold, inbound and outbound freight related to these products, packaging, and return shipping and handling costs, net of any shipping subsidy provided by our vendors.

Vendor Rebates and Allowances: We have agreements to receive cash consideration from certain of our vendors, including rebates and vendor allowances. Amounts received from our vendors in the form of rebates and vendor allowances are treated as a reduction of the prices we pay for their products and, therefore, in accordance with Emerging Issues Task Force (EITF) Issue No. 02-16, Accounting by a Customer (Including a Reseller) for Certain Consideration Received from a Vendor, we reflect such amounts as either a reduction of Cost of revenue in our consolidated statements of operations, or, if the product inventory is still on hand, as a reduction of the carrying value of inventory. Certain vendor rebates are dependent upon reaching minimum purchase thresholds. We evaluate the likelihood of reaching purchase thresholds using historical information and current year forecasts. When volume rebates can be reasonably estimated, we record a portion of the rebate as we make progress towards the purchase threshold. When we receive direct reimbursements for costs incurred by us in advertising the vendor s product or service, the amount we receive is recorded as an offset to Sales, marketing and fulfillment in our consolidated statements of operations.

Long-Lived Assets: The ability to realize long-lived assets is evaluated periodically as events or circumstances indicate a possible inability to recover their carrying amount. The analyses necessarily involve significant management judgment. Any impairment loss, if indicated, is measured as the amount by which the carrying amount of the asset exceeds the estimated fair value of the asset. When estimating the fair value of those assets, management uses selected valuation techniques, including techniques based on quoted market prices, prices for similar assets, or other valuation techniques, including estimating the undiscounted value of expected future operating cash flows to determine whether the related long-lived assets are impaired in accordance with FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*.

Intangible Assets, Net: Intangible assets include intangible assets acquired in conjunction with the purchase of certain 6pm.com assets from eBags, Inc as well as other purchased domain names, including the Clothes.com domain name. When impairment indicators exist, intangible assets are tested for impairment in accordance with FASB Statement No. 142, *Accounting for Goodwill and Other Intangible Assets*. As of December 31, 2008, no impairment charges have been recorded.

Sales, Marketing and Fulfillment: Sales, marketing, and fulfillment expenses consist primarily of customer loyalty costs, credit card fees, advertising and promotional expenses, fulfillment expenses, rent, depreciation, and payroll related to the customer loyalty, marketing and fulfillment functions.

Advertising costs, of which the majority are reported in Sales, marketing and fulfillment in our consolidated statements of operations, are expensed in accordance with the AICPA Statement of Position 93-7, *Reporting on Advertising Costs*. Advertising production costs are charged to expense the first time the advertisement runs. Online marketing fees and media (television, radio and print) placement costs are expensed as displayed or aired. Agency fees are expensed as incurred. Advertising costs were $72.4 million and $52.5 million during the years ended December 31, 2008 and 2007, respectively.

ZAPPOS.COM, INC

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

General and Administrative: General and administrative expenses consist primarily of payroll and related expenses for employees involved in general corporate functions, including finance, tax, legal, corporate IT, human resources, professional fees, litigation costs, and other general corporate costs.

Product Development: Product development expenses consist primarily of expenses associated with forecasting, maintaining and operating the Company s business, payroll and related expenses for the Company s merchandising, product information, creative services, engineering and management information systems departments.

Asset Retirement Obligations: The Company recognizes asset retirement obligations in connection with certain of its operating leases in accordance with FASB Statement No. 143, *Accounting for Asset Retirement Obligations* and FASB Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations*. We establish assets and liabilities for the present value of estimated future costs to return certain of our leased facilities to their original condition when the liability is incurred. Such assets are depreciated over the lease period into operating expense, and the recorded liabilities are accreted to the future value of the estimated restoration costs.

Stock-Based Compensation: Prior to January 1, 2006, we accounted for stock-based compensation under the intrinsic value method, which followed the recognition and measurement provisions of Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* (APB No. 25), and related interpretations, as permitted by FASB Statement No. 123, *Accounting for Stock-Based Compensation* (FASB Statement No. 123). No stock-based employee compensation cost related to stock options was recognized in the consolidated statements of operations prior to January 1, 2006, as all options granted had an exercise price equal to the fair market value of the underlying common stock on the date of grant.

Effective January 1, 2006, we adopted the fair value recognition provisions of FASB Statement No. 123 (revised 2004), *Share-Based Payment* (FASB Statement No. 123(R)), using the prospective transition method. Under the prospective transition method, share-based compensation cost recognized includes compensation cost for all share-based payments granted subsequent to January 1, 2006, based on the grant date fair value estimated using the Black-Scholes option pricing model. All share-based compensation awards issued prior to January 1, 2006 continue to be accounted for under the intrinsic value method. The Company recognizes compensation expense for stock option awards on a straight-line basis over the requisite service period of the award.

From time to time, the Company issues share-based compensation awards to non-employees for services or goods received. Those awards are measured and recognized using the fair-value method in accordance with FASB Statement 123(R) and EITF Issue No. 96-18, Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services .

Income Taxes: Income tax expense includes federal, state, and local taxes. Deferred income tax balances reflect the effect of temporary differences between the carrying amounts of assets and liabilities and their tax bases, and are stated at enacted tax rates expected to be in effect when taxes are actually paid or recovered.

FASB Statement No. 109, *Accounting for Income Taxes* (FASB Statement No. 109), requires that deferred tax assets be evaluated for future realization and reduced by a valuation allowance to the extent we believe a portion will not be realized. We consider many factors when assessing the likelihood of future realization of our deferred tax assets, including our recent cumulative earnings experience and expectations of future taxable income by taxing jurisdiction, the carryforward periods available to us for tax reporting purposes, and other relevant factors.

ZAPPOS.COM, INC

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Effective January 1, 2007, we adopted the provisions of Financial Accounting Standards Board (FASB) Interpretation (FIN) No. 48*, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109.* FIN No. 48 contains a two-step approach to recognizing and measuring uncertain tax positions in accordance with FASB Statement No. 109. The first step is to evaluate the tax position for recognition by determining if the weight of available evidence indicates it is more likely than not that the position will be sustained on audit, including resolution of related appeals or litigation processes, if any. The second step is to measure the tax benefit as the largest amount which is more than 50% likely of being realized upon ultimate settlement. We consider many factors when evaluating and estimating our tax positions and tax benefits, which may require periodic adjustments and which may not accurately anticipate actual outcomes.

Discontinued Operations: For purposes of reporting discontinued operations, the Company has determined that the individual retail store level is a component within the context of FASB Statement No. 144. A component of an entity comprises operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the Company. During the fourth quarter of 2008, the Company evaluated the results of operations of its closed retail stores both quantitatively and qualitatively to determine if the results of operations should be reported as discontinued operations. The Company referred to the guidance in EITF Issue No. 03-13, Applying the Conditions in Paragraph 42 of FASB Statement No. 144 in Determining Whether to Report Discontinued Operations when making that determination.

Contract Termination Costs: The Company accounts for contract termination costs in accordance with FASB Statement No. 146, *Accounting for Costs Associated with Exit or Disposal Activities* (FASB Statement No. 146). Costs to terminate operating leases include costs to terminate the contracts before the end of its term and costs that will continue to be incurred under the contract for its remaining term without economic benefit to the Company. The Company recognizes a liability for costs to terminate operating lease contracts before the end of their terms at fair value when the Company terminates the contract in accordance with the contract terms. It recognizes a liability for costs that will continue to be incurred under those contracts for their remaining terms without economic benefit to the Company at fair value at the cease-use date. For operating leases, the fair value of the liability at the cease-use date is determined based on remaining lease rentals and other associated costs, reduced by estimated sublease rentals that could reasonably be obtained for the properties, even when the Company does not intend to enter into subleases.

New Accounting Pronouncements: In October 2008, in response to questions that had arisen about how to measure the fair value of distressed financial assets in inactive markets, the FASB issued FSP FAS 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset is Not Active* (FSP FAS 157-3). The pronouncement provides clarifying guidance on how to apply the provisions of FASB Statement No. 157, *Fair Value* Measurements (FASB Statement No. 157), to financial assets for which previously active markets have become inactive. The pronouncement was effective upon issuance and permits entities to account for revisions to their valuation techniques as a change in accounting estimate. We do not expect that the adoption of FSP FAS 157-3 will have a material effect on our financial position or results of operations.

In April 2008, the Financial Accounting Standards Board (FASB) issued FSP FAS 142-3, *Determination of the Useful Life of Intangible Assets* (FSP FAS 142-3). FSP FAS 142-3 amends FASB Statement No. 142 such that entities may consider their own historical experience and that of other marketplace participants when determining the useful life of intangible assets that have legal, regulatory, or contractual provisions that enable renewal or extension. This pronouncement is effective for financial statements issued for fiscal years beginning after December 15, 2008 and interim periods within those fiscal years. We do not expect that the adoption of FSP FAS 142-3 will have a material impact on our financial position or results of operations.

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ZAPPOS.COM, INC

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

In accordance with the transition provisions of FASB Statement No. 157 and FASB Staff Position No. 157-2, *Effective Date of FASB Statement No. 157*, we adopted FASB Statement No. 157 on January 1, 2008 for our financial assets and financial liabilities that are recognized at fair value. For more information regarding those fair value measurements, refer to Notes 7 and 9.

In March 2008, the Financial Accounting Standards Board (FASB) issued FASB Statement No. 161, *Disclosures about Derivative Instruments and Hedging Activities an amendment of FASB Statement No. 133* (FASB Statement No. 161). This pronouncement is effective for fiscal years beginning after November 15, 2008. FASB Statement No. 161 requires certain new disclosures related to an entity s derivative and hedging activities. The adoption of FASB Statement No. 161 will not have a material impact on our financial position or results of operations.

In December 2007, the FASB issued FASB Statement No. 141 (revised 2007), *Business Combinations* (FASB Statement No. 141(R)), and FASB Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements* (FASB Statement No. 160). Both pronouncements are effective for fiscal years beginning after December 15, 2008 and early adoption is prohibited. FASB Statement No. 141(R) requires that the acquiring entity in a business combination recognize *all* the assets and liabilities acquired in the transaction. FASB Statement No. 160 requires all entities to report noncontrolling (minority) interests in subsidiaries as equity in the consolidated financial statements. Adoption of FASB Statement No. 141(R) could have a material impact on the manner under which future business combinations occurring after the FASB Statement No. 141(R) effective date are accounted for. We do not expect that adoption of FASB Statement No. 160 will have a material impact on our financial position or results of operations.

In February 2007, the FASB issued FASB Statement No. 159*, The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement 115* (FASB Statement No. 159) that provides companies with an option to report certain financial assets and liabilities in their entirety at fair value. This statement is effective for fiscal years beginning after November 15, 2007. The fair value option may be applied instrument by instrument, and may be applied only to entire instruments. A business entity would report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. The Company is evaluating its options provided for under this statement and their potential impact on its financial statements when implemented. Adoption of FASB Statement No. 159 did not have a material impact on our financial position or results of operations.

In September 2006, the FASB issued Statement No. 157, *Fair Value Measurements* (FASB Statement No. 157), which establishes a framework for measuring fair value and expands disclosures about fair value measurements. The changes to current practice resulting from the application of FASB Statement No. 157 relate to the definition of fair value, the methods used to measure fair value, and the expanded disclosures about fair value measurements. FASB Statement No. 157 is effective for years beginning after November 15, 2007 and may be adopted earlier but only if the adoption is in the first quarter of the year. We have not early-adopted the provisions of FASB Statement No. 157. The Company is evaluating the impact, if any, of adopting FASB Statement No. 157 on its financial position or results of operations. In 2007, the FASB decided to defer the effective date of FASB Statement No. 157 for all nonfinancial assets and

nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis. Adoption of FASB Statement No. 157 did not have a material impact on our financial position or results of operations.

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ZAPPOS.COM, INC

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 3 PROPERTY AND EQUIPMENT

Property and Equipment

The major classes of property and equipment, including capital leases, are as follows (in thousands):

	As of December 31, 2008	As of December 31, 2007
Software	$ 7,441	$ 5,698
Computers and equipment	10,340	7,250
Furniture and fixtures, machinery and equipment	47,146	41,883
Leasehold improvements	6,441	3,316
Construction in progress	2,056	115
	73,424	58,262
Less accumulated depreciation	(24,462)	(13,976)
Total property and equipment, net	$ 48,962	$ 44,286

Depreciation expense on property and equipment, including assets under loan obligations and capital leases, was $10.7 million and $9.5 million during the years ended December 31, 2008 and 2007, respectively. As of December 31, 2008, assets under capital leases totaled $4.7 million with accumulated depreciation of $2.3 million.

In 2008, we recognized a loss for impairment of certain long-lived assets in the amount of $0.2 million for assets related to continuing operations and $0.5 million for assets related to discontinued operations. Management determined that the carrying value of those assets was not recoverable due to declines in market prices for similar assets. The impairment loss for assets relating to continuing operations is part of Sales, marketing, and fulfillment in our consolidated statements of operations. The impairment loss for assets related to discontinued operations is part of Discontinued operations, net of tax in our consolidated statements of operations. For more information regarding closure of our retail locations, see Note 12. The review for impairment was conducted in accordance with FASB Statement No. 144, which requires a review for potential impairment if indicators of impairment arise, one such indicator being a significant adverse change in the extent or manner in which a long-lived asset is being used.

In reviewing our long-lived assets for impairment in accordance with FASB Statement No. 144, management determined that the level of usage on certain machinery and equipment had decreased significantly during 2007. Management determined that the carrying value of the machinery and equipment was not recoverable due to declines in market prices for similar assets, and recorded an impairment loss of $2.1 million as part of Sales, marketing, and fulfillment in our consolidated statements of operations. The fair value of the impaired assets was established by determining the price that could be obtained if the Company were to sell them to an independent third party in an

arms-length transaction.

Intangible Assets

In May 2008, we acquired the Clothes.com internet domain name from Idealab. The domain name was recognized as a purchased intangible asset with a useful life of 20 years. The entire purchase price of $4.9 million was assigned to the price of the domain name intangible asset and will be amortized on a straight-line basis over its remaining estimated useful life.

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ZAPPOS.COM, INC

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

In, 2007, we acquired certain assets related to the 6pm.com footwear and accessories line of business from eBags, Inc. Among the assets acquired were a minimal amount of footwear inventory, customer lists and all trademarks and domain names associated with the 6pm brand. The assets acquired from eBags did not meet the definition of a business under FASB Statement No. 141, *Business Combinations* (FASB Statement No. 141) and EITF Issue No. 98-3, Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business. In accordance with FASB Statement No. 141, the acquisition was accounted for as an acquisition of assets. The purchase price was allocated to various tangible and intangible assets, including $2.6 million for the 6pm tradename, $1.0 million for the customer relationships acquired, and $0.2 million for a non-compete agreement. The 6pm.com tradename, customer relationship, and non-compete covenant intangible assets have useful lives of 20 years, 5.5 years, and 3 years, respectively, and will be amortized on a straight-line basis over their respective useful lives. The customer relationship and the non-compete covenant intangible assets have no residual values.

The following table presents information about intangible assets at December 31, 2008 and 2007 (in thousands):

	As of December 31, 2008	As of December 31, 2007	2008 Amortization Expense	Estimated Aggregate Amortization Expense 2009	2010	2011	2012	2013
Assets subject to amortization								
Zappo.com domain name	$ 750	$ 750	$ (38)	$ (38)	$ (38)	$ (38)	$ (38)	$ (38)
Zappos.ca domain name	74		(4)	(4)	(4)	(4)	(4)	(4)
6pm non-compete agreement	167	167	(56)	(56)	(37)			
6pm customer relationships	1,027	1,027	(187)	(187)	(187)	(187)	(187)	(31)
6pm tradename	2,612	2,612	(131)	(131)	(131)	(131)	(131)	(131)
Clothes.com	4,864		(162)	(243)	(243)	(243)	(243)	(243)
Various domain names			(46)					
Total	$ 9,494	$ 4,556	$ (624)	$ (659)	$ (640)	$ (603)	$ (603)	$ (447)
Accumulated amortization								
Zappo.com domain name	$ (197)	$ (160)						
	(4)							

Zappos.ca domain name		
6pm non-compete agreement	(73)	(19)
6pm customer relationships	(249)	(62)
6pm tradename	(163)	(33)
Clothes.com	(162)	
Various domain names		
Total	$ (848)	$ (274)
Assets not subject to amortization Other intangible assets	$	$ 123
Total	$	$ 123
Intangible assets, net	$ 8,646	$ 4,405

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ZAPPOS.COM, INC

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 4 ACCRUED AND OTHER LIABILITIES

Accrued and other liabilities consist of the following (in thousands):

	As of	
	December 31, 2008	December 31, 2007
Accrued operating expenses	$ 33,956	$ 11,375
Accrued shipping expenses	8,858	3,318
Accrued payroll expenses	2,730	8,424
Deferred revenue	3,234	3,810
Gift certificate liability	2,019	1,153
Interest rate swap	510	
Other accrued liabilities	102	387
Total accrued and other liabilities	$ 51,409	$ 28,467

NOTE 5 OTHER LONG-TERM LIABILITIES

Other long-term liabilities consist of the following (in thousands):

	As of	
	December 31, 2008	December 31, 2007
Preferred stock warrant liability	$ 15,905	$ 25,575
Notes Payable	250	
FIN No. 48 liability	3,365	2,544
Interest rate swap		393
Asset retirement obligations	415	356
Total other long-term liabilities	$ 19,935	$ 28,868

The following is a reconciliation of changes in our asset retirement obligation during 2008 (in thousands):

Balance at December 31, 2007	$ 356
Liabilities incurred	
Liabilities settled	
Accretion expense	59
Revisions in estimated cash flows	
Balance at December 31, 2008	$ 415

For more information regarding the FIN No. 48 liability, refer to Note 10. For more information regarding the preferred stock warrant liability, refer to Note 9.

NOTE 6 DEBT

Loan Obligations

The Company entered into a $20.0 million secured Term Loan Facility (Term Facility) on June 30, 2006. The term loan is secured by a subordinate security interest on substantially all of our assets, though it has a senior

security interest on certain equipment in one fulfillment center. Loans funded under the Term Facility bear

ZAPPOS.COM, INC

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

interest at a fixed rate of 14.5% per annum for the first 24 months after the closing date and at a floating rate thereafter at the greater of (1) lender s reference prime rate plus 6% or (2) the rate of interest quoted in *The Wall Street Journal* as the prime rate plus 6%. Interest only payments are required for the first 24 months on the outstanding term loan, payable on the first day of each month. Principal payments of $0.2 million are required each month for months 25 through 36 after the closing date and monthly principal payments of $0.4 million are required each month for months 37 through 47 after the closing date. The Term Facility provides for certain events of default and sets forth a number of affirmative and negative covenants with which we must comply. Certain of these covenants include financial net profit and net worth covenants which are tested subject to minimum unused borrowing capacity guidelines. As of December 31, 2008, we were in compliance with our covenants. The balance of the term loan is due and payable on June 30, 2010.

The Company also entered into a variety of loan obligations for equipment in the Kentucky fulfillment centers and accounting software. The assets and liabilities under loan obligations are recorded at the lower of the present value of the minimum payments or the fair value of the asset under the agreement. Payments under the loan obligations are secured by the assets related to such agreements. The loan obligations described above consist of the following (in thousands, except where indicated):

	As of	
	December 31, 2008	December 31, 2007
$20 million Term Loan Facility; matures on June 30, 2010	$ 18,800	$ 20,000
$0.94 million Software Loan; matures on February 1, 2010 (interest is approximately 7.45% per annum)	418	727
$0.93 million Software Loan; matures on February 1, 2010 (interest is approximately 6.72% per annum)	444	771
$0.53 million Software Loan; matures on February 1, 2010 (interest is approximately 7.19% per annum)	254	442
$0.98 million Software Loan; matures on February 1, 2010 (interest is approximately 6.96% per annum)	508	884
$0.11 million Software Loan; matures on February 1, 2010 (interest is approximately 7.07% per annum)	64	111
$0.27 million Software Loan; matures on February 1, 2010 (interest is approximately 5.90% per annum)	152	
Total loan obligations	20,640	22,935
Current portion of loan obligations	(4,863)	(2,747)
Loan obligations, noncurrent	$ 15,777	$ 20,188

As of December 31, 2008, scheduled maturities of our loan obligations are as follows (in thousands):

Years Ending December 31,	
2009	$ 4,863
2010	15,777
Total	$ 20,640

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ZAPPOS.COM, INC

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Capital Lease Obligations

The Company entered into capital leases obligations for equipment in the Kentucky fulfillment center and its other facilities. The assets and liabilities under capital leases are recorded at the lower of the present value of the minimum payments or the fair value of the asset under the agreement. Payments under the capital leases are secured by the assets related to such agreements. The capital leases expire between 2008 and 2013. The future minimum payments under all noncancelable capital lease obligations at December 31, 2008 are as follows (in thousands):

Years Ending December 31,	
2009	$ 1,649
2010	1,316
2011	466
2012	60
2013	2
Total minimum payments	3,493
Less amounts representing interest	(301)
Present value of minimum payments	3,192
Less current portion	(1,490)
Long-term portion	$ 1,702

Revolving Line of Credit

Zappos has a revolving line of credit agreement with its lenders pursuant to the terms of a revolving credit and security agreement dated January 23, 2006, as amended (the Line of Credit Agreement). During the year ended December 31, 2008, the line limit was increased to $80.0 million. As of December 31, 2008, the unused borrowing capacity after reserves on the facility was $48.1 million. The maximum commitment from our lenders is $100.0 million, subject to available collateral, which is calculated based, in part, on the carrying value of our inventory. The weighted-average interest rate on the Line of Credit Agreement for the periods ended December 31, 2008 and 2007 4.5% and 6.6%, respectively. The line of credit expires on June 30, 2010 and may be repayable at Wells Fargo s discretion in the event of a default if a material adverse change in our business has occurred.

Amounts borrowed under the Line of Credit Agreement bear interest at rates equal to the lenders effective interest rate calculated on the daily outstanding loan balance. The lenders interest rate on the revolving line is either the lower of the lenders reference prime rate or London Interbank Offer Rate + 1.5%. The Line of Credit Agreement provides for certain events of default and sets forth a number of affirmative and negative covenants with which we must comply. Certain of these covenants include consolidated net leverage ratio, financial net profit, and book net worth covenants, which are tested when our minimum liquidity covenant is not met. During 2008 and as of December 31, 2008, we were in compliance with our minimum liquidity covenant.

As described in Note 2, we are required to maintain a restricted cash account which is used to deposit all cash received from our customers. Such cash is applied to pay down the facility on a daily basis. In accordance with EITF Issue No. 95-22, Balance Sheet Classification of Borrowings Outstanding Under Revolving Credit Agreements That Include a Subjective Acceleration Clause and a Lock-Box Arrangement, we are required to classify the revolving line of credit as a current liability. We have the ability to redraw down on the line as long as we are not in violation of any of the financial covenants contained in the Line of Credit Agreement or otherwise in default.

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ZAPPOS.COM, INC

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Interest Costs Incurred

The Company incurred the following interest costs during the years ended December 31, 2008 and 2007:

	For the twelve months ended December 31, 2008	2007
Other interest expense	$ 5,825	$ 6,930
Capitalized interest	93	134
Total interest costs incurred	$ 5,918	$ 7,064

NOTE 7 DERIVATIVE FINANCIAL INSTRUMENTS

Interest Rate Swap

In 2005, Zappos entered into a swap agreement to effectively fix the interest rate for up to $24.0 million of our revolving line of credit. The swap agreement was designated as a cash flow hedge under FASB Statement No. 133. Due to a change in the terms of the interest rate swap, the hedge designation was removed in 2007 because the Company could no longer assume perfect hedge effectiveness. We recognized changes to the fair value of the interest rate swap which resulted in an expense of $0.1 million and $0.5 million during the years ended December 31, 2008 and 2007, respectively. The change was recorded as a component of Interest expense.

The following table denotes the fair value of our interest rate swap at December 31, 2008 and the respective measurement level under FASB Statement No. 157 (in thousands):

		Fair Value Measurements at Reporting Date Using		
	As of December 31, 2008	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Interest rate swap	$ 510	$	$ 510	$
Total	$ 510	$	$ 510	$

NOTE 8 STOCKHOLDERS EQUITY

At December 31, 2008, our capital stock consists of the following (in thousands):

	Shares		Liquidation
	Authorized	Outstanding	Preference
Series A preferred stock	1,550	1,491	$ 149
Series B preferred stock	7,725	4,514	880
Series C preferred stock	17,300	15,796	7,151
Series D preferred stock	650	428	338
Series E preferred stock	5,000	3,247	80,000
Series F preferred stock	3,772	3,772	92,948
Total Preferred Stock	35,997	29,248	$ 181,466
Common	60,000	15,916	$
Total Common Stock	60,000	15,916	$

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ZAPPOS.COM, INC

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Convertible Preferred Stock

The Series A, B, C, D, E and F preferred stock are convertible into common stock at the option of the stockholder into such number of fully paid and nonassessable shares of common stock as is determined by dividing the original issue price for the relevant series of preferred stock by the then applicable conversion price in effect at the time of conversion, subject to antidilution adjustments. Conversion is automatic upon a firm underwritten public offering of not less than $10 million for Series A, B, C and D and $40 million for Series E and F, with a per share price not less than $3.50 for Series A, B, C and D and $24.64 for Series E and F, or the affirmative vote or written consent of more than a 50% majority of holders of the outstanding shares of a series of preferred stock, which will trigger automatic conversion for shares of the relevant series of preferred stock only. Conversion could also be subject to adjustments to the conversion price, providing for certain events that may occur as outlined in our Articles of Incorporation, as amended. In accordance with EITF Issue Nos. 98-5, Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios and 00-27, Application of Issue 98-5 to Certain Convertible Instruments, the Company determined that the existing conversion features on the convertible preferred stock did not result in a beneficial conversion option at the dates of issuance.

The holders of Series E and F preferred stock are entitled to receive noncumulative dividends, when and if declared, at an annual rate equal to $0.4928 and $0.72 per share for each outstanding share of the series of preferred stock, respectively, in preference and priority to any payment of any dividend on the holders preferred stock of A, B, C and D.

After the holders of Series E and F preferred stock have received their full dividend preference as set forth above, the holders of series A, B, C and D preferred stock are entitled to receive noncumulative dividends, when and if declared, at an annual rate equal to $0.015592, $0.015592, $0.036218 and $0.06328 per share for each outstanding share of the series of preferred stock, respectively, in preference and priority to any payment of any dividend on common stock of Zappos. After the payment of dividends to the holders of preferred stock, dividends may be declared and distributed equally among all holders of common stock. As of December 31, 2008, no dividends had been declared or paid.

In the event of liquidation, dissolution or winding up of Zappos, either voluntary or involuntary, the holders of the preferred stock will be entitled to receive, prior and in preference to any distribution of any assets or surplus funds to the holders of the common stock by reason of their ownership of such stock, in the amount of $0.1000 per share for each share of Series A preferred stock then held by them, $0.1949 per share of Series B preferred stock then held by them, $0.4527 per share of Series C preferred stock then held by them, $0.7910 per share of Series D preferred stock then held by them, and $24.6400 per share for series E and F preferred stock then held by them, respectively, plus an amount equal to all declared but unpaid dividends on such shares. The excess will be distributed ratably among the holders of common stock. If the assets and funds thus distributed among the holders of the preferred stock should be insufficient to permit the full payment for each series, then the entire assets and funds of Zappos legally available for distribution will be distributed first ratably among the holders of the Series E and F preferred stock in proportion to their relative aggregate preferred stock liquidation preference amounts, then second ratably to the holders of the Series A preferred stock until such holders have received their total aggregate preferred stock

liquidation preference amount, then third among the holders of Series B and C preferred stock in proportion to their relative aggregate preferred stock liquidation preference amounts, and then fourth ratably to the holders of the Series D preferred stock.

The holder of each share of common stock issued and outstanding will have one vote and the holder of each share of Series A, B, C, D, E and F preferred stock will be entitled to the number of votes equal to the number of shares of common stock into which such share of preferred stock could be converted at the record date.

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ZAPPOS.COM, INC

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Stock Repurchases

In 2007, our Board of Directors authorized the repurchase of 0.50 million common shares for an aggregate purchase price of $3.0 million. The repurchase occurred on April 12, 2007, and those shares were retired and reclassified as authorized and unissued shares of common stock.

NOTE 9 STOCK OPTIONS AND WARRANTS

Stock Option Plan

At December 31, 2008, Zappos has one stock-based compensation plan, which is described below. Compensation cost recorded under this plan was $2.9 million and $2.0 million for the years ended December 31, 2008 and 2007, respectively. Related income tax benefit recognized in the statement of operations related to this plan was $0.4 million and $0.5 million for the years ended December 31, 2008 and 2007, respectively. Zappos did not capitalize any compensation cost in 2008 or 2007.

In August 1999, Zappos adopted the 1999 Stock Plan (the 1999 Plan), which provides for the issuance of options and restricted stock for up to 5.4 million shares of our common stock to qualified directors, employees, and consultants. When options issued under the 1999 Plan are exercised, shares of common stock are issued to the option holder in accordance with the 1999 Plan.

In May 2008, Zappos increased the number of shares reserved under the 1999 Plan by 1.5 million to 11.3 million shares.

In April 2007, Zappos increased the shares reserved under the 1999 Plan by 1 million to 9.8 million shares.

Under the 1999 Plan, in the case of an incentive or non-statutory stock option, options to purchase common stock and restricted stock awards may be granted at: (1) no less than 110% of the fair market value per share on the date of grant to an employee or service provider who, at the time of the grant of such option, owns stock representing more than 10% of the voting power of all classes of the stock of Zappos or any parent or subsidiary; or (2) no less than 100% of the fair market value per share on the date of the grant to any other employee; or (3) no less than 85% of the fair market value per share on the date of grant to any other service provider, as determined by our Board of Directors. Options generally vest over a 48-month period and have a maximum term of ten years. Restricted stock awards are subject to repurchase rights in favor of Zappos, which generally shall in no case lapse at a rate of less than 20% per year over five years from the date of purchase.

The stock-based compensation expense was as follows (in thousands):

	For the twelve months ended December 31,

	2008	2007
Sales, marketing, and fulfillment	$ 219	$ 136
General and administrative	1,815	1,497
Product development	850	363
Total earned stock-based compensation	$ 2,884	$ 1,996

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ZAPPOS.COM, INC

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

A summary of stock option activity under the 1999 Plan as of December 31, 2008, and changes during the year then ended is presented below (amounts in thousands, except amounts in dollars and average remaining contractual life):

	Shares	Weighted-Average Exercise Price Per Share	Weighted-Average Average Remaining Contractual Life (years)	Aggregate Intrinsic Value (thousands)
Balance at January 1, 2007	5,412	1.564		
Options granted	1,782	7.969		
Options exercised	(671)	0.303		
Options canceled/forfeited	(339)	5.686		
Balance at December 31, 2007	6,184	3.248		
Options granted	669	12.750		
Options exercised	(1,727)	0.671		
Options canceled/forfeited	(302)	6.017		
Balance at December 31, 2008	4,824	5.204	6.7	$ 12,303
Vested and unvested expected to vest at December 31, 2008	4,749	5.204	6.7	$ 12,114
Exercisable at December 31, 2008	3,474	3.269	5.9	$ 12,072

The weighted-average grant-date fair value of options granted during the years 2008 and 2007 was $7.64 and $4.66, respectively. The total intrinsic value of options exercised during the years ended December 31, 2008 and 2007 was $16.2 million and $4.6 million, respectively.

A summary of the status of Zappos nonvested shares as of December 31, 2008, and changes during the year ended December 31, 2008, is presented below (amounts in thousands, except per-share amounts):

	Shares	Weighted-Average Grant-Date Fair Value
Unvested at January 1, 2007	2,433	$ 4.41
Granted	669	$ 7.64
Vested	(1,088)	$ 3.41
Forfeited	(227)	$ 3.83
Unvested at December 31, 2008	1,787	$ 5.64

As of December 31, 2008, there was $10.1 million of total unrecognized compensation cost related to nonvested stock-based compensation arrangements granted under the 1999 Plan. That cost is expected to be recognized over a weighted-average period of 2.3 years. The total fair value of shares vested during 2008 and 2007 was $3.5 million and $1.1 million, respectively.

In 2007, management reviewed the assumptions used to determine the fair value of stock options under the Black-Scholes option pricing model. Management has adjusted the weighted-average expected term from 10 years to 6.25 years and changed the risk-free interest rate to match the weighted-average expected term. Because of the plain vanilla nature of our stock options, we value them under a simplified method under SEC Staff Accounting Bulletin No. 107, *Share-Based Payment* (SAB 107).

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ZAPPOS.COM, INC

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The fair value of stock options was estimated at the date of grant using the Black-Scholes option pricing model with the following adjusted weighted-average assumptions:

	For the twelve months ended December 31,	
	2008	**2007**
Risk-free interest rates[1]	3.4 - 3.7%	3.8 - 5.0%
Dividend yield		
Volatility[2]	60%	60%
Weighted-average expected term[3]	6.3 years	6.3 years
Expected forfeiture rate[4]	1.3% - 2.2%	2.1%

(1) Based upon an average of the 5 and 10 year U.S. Treasury zero-coupon issues at the time of grant.
(2) Estimated based on other publicly traded companies within the same industry.
(3) Represents the period of time options are expected to be outstanding.
(4) Based upon historical experience.

Cash received from option exercise under the 1999 Plan during the years ended December 31, 2008 and 2007 was $0.3 million and $0.2 million, respectively. The tax benefit realized from options exercised totaled $1.4 million and $0.4 million for the years ended December 31, 2008 and 2007, respectively.

Warrant

In January 2000, Zappos issued an immediately exercisable and fully vested warrant to purchase 2.6 million shares of Series B preferred stock at a per share price of $0.3025. The warrant was ratified by Zappos board in May 2000. The warrant expires on the earlier of the following dates: (a) January 10, 2010, (b) the merger or consolidation of Zappos into a third party pursuant to which our stockholders own less than 50% of the surviving entity, (c) the sale of substantially all of our assets, or (d) our initial public offering.

The calculated fair value of the warrant at the date of issuance was $0.44 million. We valued the warrant using the Black-Scholes valuation model with the following assumptions: risk-free interest rate of 6.92%, contractual life of 10 years, an expected volatility of 100%, an exercise price of $0.30245 and no expected dividend yield.

At December 31, 2008, the warrant for 2.6 million shares of Series B convertible preferred stock remains outstanding. The warrant is classified as a liability and recognized at fair value with changes to fair value recognized in income under FSP No. 150-5.

The calculation of fair value of the warrant requires the input of highly subjective assumptions and changes in those assumptions could materially affect the fair value estimates. The Company will continue to adjust the warrant liability for changes in fair value until the earlier of the exercise of the warrants or the completion of a liquidation

event, including the completion of an initial public offering, at which time the liability will be reclassified to stockholders equity (deficit).

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ZAPPOS.COM, INC

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The Company estimated the fair value of the warrant using the Black-Scholes option-pricing model. The assumptions used in the model to value the warrant were as follows:

	For the twelve months ended December 31,	
	2008	**2007**
Remaining contractual term	1.0 - 2.0 years	2.0 - 2.5 years
Blended risk-free interest rate	0.4% - 2.5%	3.1% - 4.9%
Expected volatility	60%	60%
Expected dividend yield	0%	0%

The fair value of the underlying preferred shares was assessed in accordance with AICPA Technical Practice Aid, Valuation of Privately-Held Company Equity Securities Issued as Compensation (2004).

Because the warrant is measured at fair value on a recurring basis, the measurement is subject to the provisions of FASB Statement No. 157. The measurement of the warrant falls under Level 3 of the fair value measurement hierarchy. The fair value of the warrant as of December 31, 2008 and 2007 was $15.9 million and $25.6 million, respectively. We recognized changes to the fair value of the warrant which resulted in a benefit of $9.7 million and an expense of $10.8 million in the years ended December 31, 2008 and 2007, respectively, to reflect the change in the fair value of the warrant. The change was recorded as a component of Interest benefit (expense) associated with preferred stock warrant .

The following table illustrates a reconciliation of the beginning and ending balances of items measured under Level 3 of the fair value measurement hierarchy of FASB Statement No. 157. Currently the warrant is the only item measured under this level (in thousands):

	Fair Value Measurements Using Significant Unobservable Inputs (Level 3)	
	Warrant	**Total**
Beginning balance at December 31, 2007	$ 25,575	$ 25,575
Total gains included in earnings	(9,670)	(9,670)
Purchases, issuance, and settlements		
Transfers in and/or out of Level 3		
Ending balance at December 31, 2008	$ 15,905	$ 15,905

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ZAPPOS.COM, INC

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Shares Reserved

Common stock reserved for future issuance is as follows (in thousands):

	As of	
	December 31, 2008	December 31, 2007
Reserved for outstanding stock options	4,823	6,184
Reserved for future stock grants	1,835	593
Stock warrants	2,565	2,565
Series A preferred stock conversion	1,491	1,528
Series B preferred stock conversion	4,514	4,514
Series C preferred stock conversion	15,796	15,796
Series D preferred stock conversion	428	428
Series E preferred stock conversion	3,247	3,247
Series F preferred stock conversion	3,772	3,772
Total common stock reserved for future issuance	38,471	38,627

NOTE 10 INCOME TAXES

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

	Year Ended December 31,	
	2008	2007
Benefit (provision) for income taxes:		
Current:		
Federal	$ (2,296)	$ (7,933)
State	(22)	(493)
Total Current	$ (2,318)	$ (8,426)
Deferred:		
Federal	$ 775	$ 747
State	153	(401)
Total Deferred	$ 928	$ 346
Equity adjustments:		
Federal	$ (1,256)	$ (426)
State	(46)	(17)
Total equity adjustments	$ (1,302)	$ (443)

Total provision for income taxes	$ (2,692)	$ (8,523)
Income tax benefit for discontinued operations (see Note 12)	$ 2,516	$ 1,765
Total provision for income taxes from continuing operations	$ (5,208)	$ (10,288)

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ZAPPOS.COM, INC

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The difference between the statutory federal income tax rate and the effective income tax rate are provided in the following reconciliation:

	Year Ended December 31,	
	2008	2007
Statutory federal income tax rate	34.0%	35.0%
Increase (decrease) in taxes resulting from:		
Valuation allowance	0.0%	0.0%
Meals and entertainment	2.7%	3.1%
State taxes	(0.7)%	7.2%
Interest expense preferred stock warrant	(25.1)%	36.8%
Stock options	2.5%	2.3%
Other	5.8%	(1.6)%
Effective tax rate	19.2%	82.8%

The significant components of net deferred tax assets and liabilities as of December 31, 2008 and 2007 consisted of the following (in thousands):

	December 31,	
	2008	2007
Deferred tax assets:		
Net operating loss carryforwards	$ 456	$ 685
Sales returns reserves	6,342	5,840
Employee benefits	471	251
Inventory	3,417	2,146
Other reserves	2,366	1,791
Deferred rent	605	764
FIN No. 48		2,412
Stock options	997	
Other	2,184	1,483
Gross deferred tax assets	$ 16,838	$ 15,372
Deferred tax liabilities:		
Depreciation	$ 2,870	$ 3,417
Other	559	268
Gross deferred tax liabilities	$ 3,429	$ 3,685
Less Valuation Allowance	$ 240	$ 267
Net deferred tax asset	$ 13,169	$ 11,420

As of December 31, 2008, the Company had available federal net operating loss carryforwards of approximately $0.8 million which expire during the years 2014 through 2022. At December 31, 2008, the Company had available $4.1 million state (California) net operating loss carryforwards which expire during the years 2010 through 2013. Currently there is a valuation allowance on the Deferred Tax Asset for $0.24 million. This allowance relates to California Net Operating Losses that the Company may not be able to realize in the future. The use of certain net operating loss carryforwards are subject to annual limitations based on ownership changes of the Company s stock, as defined by Section 382 of the Internal Revenue Code and Section 24416 of the California Revenue and Taxation Code. The annual limitation may result in the expiration of the net operating losses before utilization.

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ZAPPOS.COM, INC

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Tax Contingencies

Effective January 1, 2007, we adopted the provisions of FASB Interpretation No. 48, *Accounting for Uncertainty in Income* Taxes (FIN No. 48). As a result of the implementation of FIN No. 48, we recognized an increase of approximately $2.75 million in the liability for unrecognized tax benefits (tax contingencies). This was accounted for as a reduction of $0.50 million to the January 1, 2007 balance of retained earnings, which would otherwise have increased our income tax expense in prior periods.

We do not believe we have tax contingency positions that are reasonably likely to change significantly within the next twelve months. A reconciliation of the beginning and ending amount of tax contingencies is as follows (in thousands):

	2008	2007
Balance at January 1	$ 2,544	$ 2,747
Additions based on tax positions related to the current year	6	1,365
Additions for tax positions of prior years	933	
Reductions for tax positions of prior years		(939)
Reductions due to settlements with taxing authorities		(499)
Reductions due to lapse of statute of limitations	(118)	(130)
Balance at December 31	$ 3,365	$ 2,544

We file tax returns as prescribed by the laws of the jurisdictions in which we operate. We are subject to U.S. income tax examinations for the years 1999 through 2007 as NOLs from 1999 through 2002 have been utilized on later returns. Our federal income tax returns are currently under examination for the years ended December 31, 2006 and 2005.

As of December 31, 2008, there was a total of $3.2 million of unrecognized tax benefits that, if recognized, would affect the effective tax rate. We recognize interest and penalties related to our tax contingencies as income tax expense.

NOTE 11 COMMITMENTS AND CONTINGENCIES

Legal Proceedings

The Company is involved in various litigation incidental to its business, including claims relating to infringement of intellectual property rights of third parties and claims relating to the manner in which goods are sold through its ecommerce platform.

The Company has evaluated those claims in accordance with FASB Statement No. 5, *Accounting for Contingencies*. With respect to one claim made against the Company in November 2007 for technology-related patent infringement, in November 2008, the Company entered into a forward-looking licensing agreement with a third party, Soverain Software LLC (Soverain) for continued use of certain patents that were in

dispute. During the second quarter of 2008, we determined that it was probable that we would enter into such an agreement and recognized an estimated liability related to the probable settlement. Based on the terms of the final agreement, we recognized additional liability during the third quarter of 2008. The majority of the license fee relates to future periods.

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ZAPPOS.COM, INC

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The company has determined that any losses resulting from other claims are not probable to result in material losses. However, the Company may incur substantial expenses and devote substantial time to defend third-party claims whether or not such claims are meritorious. In the event of a determination adverse to the Company, the Company may incur substantial monetary liability and may be required to implement expensive changes in its business practices or enter into costly royalty or licensing agreements.

Operating Leases

Zappos has entered into operating leases for fulfillment centers, office space, retail stores, and computer equipment.

We maintain our corporate headquarters in Henderson, Nevada in leased facilities of approximately 109,227 square feet. The leases for these facilities expire on December 31, 2009.

During 2008, we maintained retail locations in Las Vegas, Nevada and Henderson, Nevada in leased facilities of approximately 68,901 square feet. The leases for these facilities originally expired between 2010 and 2012. We also maintained retail locations in Shepherdsville, Kentucky and Bowling Green, Kentucky in leased facilities of approximately 38,500 square feet. The leases for these facilities originally expired between 2010 and 2016. During the fourth quarter of 2008, we discontinued operations in our Nevada and Bowling Green, Kentucky retail locations. See Note 12 for further discussion regarding the discontinuation of operations in those retail locations.

We have warehouse and distribution facilities in Shepherdsville, Kentucky in leased facilities of approximately 892,900 square feet. The leases for these facilities expire between 2014 and 2016.

The future minimum lease payments under all noncancelable operating leases at December 31, 2008 are as follows (in thousands):

Years Ending December 31,	
2009	$ 6,891
2010	4,051
2011	4,255
2012	4,296
2013	4,296
Thereafter	7,675
Total minimum payments	$ 31,464

Rental expenses were $7.1 million and $6.3 million for the years ended December 31, 2008 and 2007, respectively.

Advertising and Media Agreements

As of December 31, 2008, the Company was contractually committed for the purchase of future advertising totaling approximately $1.6 million through 2010. Our payments related to these future advertising and media commitments at December 31, 2008 are as follows:

Years Ending December 31,	
2009	$ 1,302
2010	335
Total minimum payments	$ 1,637

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ZAPPOS.COM, INC

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 12 DISCONTINUED OPERATIONS

During the fourth quarter of 2008, the Company discontinued operations in its Nevada and Bowling Green, Kentucky retail stores. The company ceased all operations at those stores during the last two weeks of December and terminated the lease agreements for one of the Nevada stores and, when required, entered into agreements with the landlords of the other stores that permitted the Company to cease operations.

The Company has presented the operating results of those stores as discontinued operations in the statement of operations for all years presented. The operating results include lease contract termination costs, one-time termination benefits that were provided to employees that were involuntarily terminated, and the write-off of equipment that was disposed of as part of the closure of the retail stores. The following amounts have been segregated from continuing operations and included in discontinued operations (in thousands):

	Years Ended December 31,	
	2008	2007
Revenues	$ 3,844	$ 1,640
Costs and expenses:		
Cost of revenues	7,231	3,434
Sales, marketing and fulfillment	8,494	3,055
Total costs and expenses	15,725	6,489
Loss from discontinued operations before income taxes	(11,881)	(4,849)
Income tax benefit	2,516	1,765
Net loss from discontinued operations	$ (9,365)	$ (3,084)

The Company has recognized the fair value of the liabilities incurred for contract termination costs and one-time termination benefits in accordance with FASB Statement No. 146. As of December 31, 2008, the fair value of those liabilities was $3.2 million for contract termination costs and $0.1 million for one-time termination benefits, all of which were expensed during the fourth quarter of 2008. The cumulative amount incurred to date is $3.8 million, which includes $0.4 million of contract termination costs paid in 2008. Those costs are aggregated in Discontinued operations, net of tax in the Consolidated Statements of Operations. The Company does not expect to incur material additional contract termination costs or one-time termination benefits in 2009 related to the discontinuation of operations for those retail stores closed in 2008.

The following is a reconciliation of changes in our contract termination costs and one-time termination benefits during 2008 (in thousands):

	Contract Termination Costs	One-Time Termination Benefits
Balance at December 31, 2007	$	$
Costs incurred and charged to expense	3,246	143
Costs paid or otherwise settled	428	
Adjustments		
Balance at December 31, 2008	$ 3,674	$ 143

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ZAPPOS.COM, INC

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 13 SUPPLEMENTAL CASH FLOW INFORMATION

Supplemental cash flow information was as follows (in thousands):

	For the twelve months ended December 31,	
	2008	2007
Supplemental disclosure of cash flow information		
Cash paid for interest	$ 5,815	$ 7,804
Cash paid for income taxes	$ 6,402	$ 6,427
Supplemental disclosure of noncash financing activities		
Capital lease obligations incurred	$ 1,509	$ 2,663
Net unrealized holding gain on derivative instruments	$	$ (124)
Acquisition of property and equipment with short-term, non interest bearing seller financing	$	$ (896)
Supplemental disclosure of noncash investing activities		
Asset retirement obligation incurred	$	$

NOTE 14 SAVINGS PLAN

Zappos sponsors a 401(k) Plan, which provides that eligible employees may, subject to certain limitations, contribute to the 401(k) Plan, subject to certain limitations, up to 50% of eligible compensation on a pretax basis. Full-time employees are eligible to participate in the 401(k) Plan beginning the first month after the date of hire. Pursuant to the 401(k) Plan, we do not match any employee contributions.

NOTE 15 SUBSEQUENT EVENTS

In March 2009, we entered into an agreement with a third party under which the third party will provide consulting services in connection with the implementation of new merchandising software. The software will result in substantial changes being made to our legacy applications and vendor management process. Implementation is expected to be completed during the first half of 2010. The consulting fees are expected to be approximately $7.9 million.

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APPENDIX E

CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Zappos.com, Inc.

Three and six months ended June 30, 2009

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Zappos.com, Inc.

Consolidated Financial Statements

(unaudited)

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Report of Independent Accountants

To the Board of Directors and Shareholders of Zappos.com, Inc.:

We have reviewed the accompanying consolidated balance sheet of Zappos.com, Inc. (the Company) as of June 30, 2009 and December 31, 2008 and the related consolidated statements of operations for the three and six-month periods ended June 30, 2009 and 2008, the consolidated statements of cash flow for the six-month period ended June 30, 2009 and the consolidated statement of stockholders equity and comprehensive income as of June 30, 2009. These interim financial statements are the responsibility of the Company s management.

We conducted our review in accordance with the standards generally accepted in the United States of America. A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards generally accepted in the United States of America, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the accompanying consolidated interim financial statements for them to be in conformity with accounting principles generally accepted in the United States of America.

This report is intended solely for the information and use of management and the Board of Directors of Zappos.com and is not intended to be and should not be used by anyone other than these specified parties.

PricewaterhouseCoopers LLP

San Jose, California

September 11, 2009

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ZAPPOS.COM, INC.

CONSOLIDATED BALANCE SHEETS

(unaudited)

(in thousands)

	June 30, 2009	As of December 31, 2008
Assets		
Current assets:		
Cash and cash equivalents	$ 4,470	$ 8,590
Restricted cash	2,176	2,245
Accounts receivable, net	5,039	6,772
Inventory, net	176,918	168,131
Deferred income taxes	15,890	15,890
Prepaid expenses and other assets	3,328	3,253
Total current assets	207,821	204,881
Property and equipment, net	49,069	48,962
Deferred income taxes	708	708
Intangible assets, net	8,296	8,646
Other assets, net	1,860	2,075
Total assets	$ 267,754	$ 265,272
Liabilities and stockholders equity		
Current liabilities:		
Accounts payable	$ 61,823	$ 69,792
Accrued and other liabilities	76,464	51,409
Deferred income taxes	559	559
Accrued sales returns	13,988	18,637
Current portion of loan obligations	18,722	4,863
Current portion of capital lease obligations	3,046	1,490
Revolving line of credit	35,000	26,006
Total current liabilities	209,602	172,756
Deferred rent	1,467	1,514
Deferred income taxes	2,870	2,870
Other long term liabilities	3,748	19,935
Loan obligations, noncurrent		15,777
Capital lease obligations, noncurrent	3,734	1,702
Total liabilities	221,421	214,554
Stockholders equity:		
Convertible preferred stock; $0.001 par value; 35,997 authorized, 29,248, and 29,248 issued and outstanding (aggregate liquidation preference $181,466 and $181,469)	61,465	61,465
Common stock; $0.001 par value; 60,000 authorized, 15,970 and 15,916 issued and outstanding	16	16
Additional paid-in capital	8,275	6,557

Accumulated deficit	(23,423)	(17,320)
Total stockholders equity	46,333	50,718
Total liabilities and stockholders equity	$ 267,754	$ 265,272

See accompanying notes to consolidated financial statements

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ZAPPOS.COM, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

(unaudited)

(in thousands)

	For the three months ended June 30,		For the six months ended June 30,	
	2009	2008	2009	2008
Net revenues	$ 165,236	$ 152,613	$ 309,099	$ 285,323
Cost of revenues	106,555	97,158	201,092	181,406
Gross profit	58,681	55,455	108,007	103,917
Operating expenses:				
Sales, marketing and fulfillment	36,870	37,862	71,688	70,792
General and administrative	5,788	5,870	10,989	11,997
Product development	5,767	6,154	11,514	12,443
Total operating expenses	48,425	49,886	94,191	95,232
Income from operations	10,256	5,569	13,816	8,685
Interest and other income, net	101	133	173	325
Interest expense associated with preferred stock warrant	(12,441)	(5,771)	(13,721)	(5,746)
Other interest expense	(826)	(1,067)	(1,775)	(2,814)
Other financing charges	(102)	(121)	(226)	(280)
(Loss) income before provision for income taxes	(3,012)	(1,257)	(1,733)	170
Provision for income taxes	(3,343)	(1,562)	(4,356)	(1,550)
Net loss from continuing operations	$ (6,355)	$ (2,819)	$ (6,089)	$ (1,380)
Discontinued operations, net of tax	30	(679)	(14)	(1,525)
Net loss	$ (6,325)	$ (3,498)	$ (6,103)	$ (2,905)

See accompanying notes to consolidated financial statements

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ZAPPOS.COM, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited)

(in thousands)

	For the six months ended June 30,	
	2009	2008
Operating activities		
Net loss	$ (6,103)	$ (2,905)
Adjustments to reconcile net loss to net cash used in operating activities:		
Amortization of deferred financing costs	150	157
Depreciation and amortization	6,632	5,252
Asset retirement obligation	35	26
Reserves on returns	(4,649)	(2,772)
Provision for bad and doubtful debt	(132)	90
Provision for excess and obsolete inventory	585	917
Stock-based compensation	1,709	1,283
Loss on disposal of property and equipment	26	15
Change in carrying value of preferred stock warrant	13,723	5,746
Changes in operating assets and liabilities:		
Credit card and other receivables	1,865	1,342
Merchandise inventory	(9,372)	(20,386)
Prepaid expenses and other assets	(161)	(4,197)
Accounts payable	(7,323)	(6,272)
Accrued and other liabilities	(4,847)	(4,382)
Net cash used in operating activities	(7,862)	(26,086)
Investing activities		
Purchase of property and equipment	(7,153)	(5,793)
Purchase of intangible assets		(4,850)
Proceeds from disposal of property and equipment	4,941	
Increase in restricted cash		(7)
Net cash used in investing activities	(2,212)	(10,650)
Financing activities		
Proceeds from exercise of employee stock options	9	262
Decrease (increase) in restricted cash	69	(1,407)
Borrowings under revolving line of credit	311,916	333,570
Repayment of borrowings under revolving line of credit	(302,919)	(299,231)
Borrowings under loans		271
Repayment of loans	(1,919)	(672)
Payment of capital leases	(1,202)	(559)
Net cash provided by financing activities	5,954	32,234
Change in cash and cash equivalents	(4,120)	(4,502)
Cash and cash equivalents at beginning of period	8,590	6,761
Cash and cash equivalents at end of period	$ 4,470	$ 2,259

Supplemental disclosure of cash flow information				
Cash paid for interest	$	1,811	$	2,794
Cash paid for income taxes	$	2,050	$	4,454

See accompanying notes to consolidated financial statements

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ZAPPOS.COM, INC.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY AND COMPREHENSIVE INCOME

(unaudited)

(in thousands)

	Convertible Preferred Stock		Common Stock		Additional Paid-in Capital	Accumulated Deficit	Total Stockholders Equity
	Shares	Amount	Shares	Amount			
Balance at December 31, 2008	29,248	$ 61,465	15,916	$ 16	$ 6,557	$ (17,320)	$ 50,718
Net income						(6,103)	(6,103)
Exercise of stock options			58		35		35
Vested options cancelled through exchange			(4)		(26)		(26)
Stock-based compensation					1,709		1,709
Balance at June 30, 2009	29,248	$ 61,465	15,970	$ 16	$ 8,275	$ (23,423)	$ 46,333

See accompanying notes to consolidated financial statements

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ZAPPOS.COM, INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 DESCRIPTION OF BUSINESS

Zappos.com, Inc. (Zappos, we, our, or the Company), a California corporation founded in 1999, is an online retailer that sells apparel, shoes, handbags, eyewear, watches, electronics and other products. Among the other value added services we offer our brand partners is our Powered By Zappos program (PBZ), introduced in 2006. Under PBZ, Zappos designs and operates most, if not all, aspects of a retailer s website, including website design, hosting, fulfillment, returns and customer inquiries. Zappos is the seller of record of all merchandise processed through the PBZ program, yet works closely with the retailer to achieve the desired look and feel of the website.

NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation: The accompanying condensed financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information. The year-end condensed balance sheet data was derived from audited financial statements, but does not include all disclosures required by generally accepted accounting principles in the United States of America for complete financial statements. These statements have been prepared on a basis that is consistent with the accounting principles applied in our Annual Report for the year ended December 31, 2008. These financial statements are unaudited and, in our opinion, include all adjustments, consisting of normal recurring adjustments and accruals necessary for a fair presentation of our balance sheet, operating results, statement of stockholders equity, and cash flows for the periods presented. Operating results for the three and six months ended June 30, 2009 are not necessarily indicative of the results that may be expected for the year ending December 31, 2009.

These unaudited interim condensed consolidated financial statements should be read in conjunction with the audited financial statements and accompanying notes included for the year ended December 31, 2008.

Reclassifications: During the fourth quarter of 2008, the Company discontinued operations in its Nevada and Bowling Green, Kentucky retail stores. The results of operations for those stores have been reclassified from the results of operations from continuing operations to discontinued operations, net of tax.

New Accounting Pronouncements: In June 2009, the FASB issued FASB Statement No. 166, *Accounting for Transfers of Financials Assets,* and No. 167, *Amendments to FASB Interpretation No. 46(R)*, which change the way entities account for securitization and special-purpose entities. The new pronouncements will not have a material impact on our financial position or results of operations.

In May 2009, the FASB issued FASB Statement No. 165, *Subsequent Events* (FASB Statement 165). The pronouncement establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before the financial statements are issued or are available to be issued. The pronouncement is effective for interim and annual periods ending after June 15, 2009, and since it should not result in a significant change to current practice, management does not expect that it will have a material impact on our financial position or results of operations.

In April 2009, the FASB issued FASB Staff Position No. 115-2 and 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments,* to provide guidance for

assessing whether an impairment of a debt security is other than temporary, as well as how such impairments are presented and disclosed in the financial statements. The adoption of the new pronouncement, which was effective for interim and annual reporting periods ending after June 15, 2009, did not have a material impact on our financial position or results of operations.

For more information regarding our significant accounting policies, refer to our annual report for the year ended December 31, 2008.

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ZAPPOS.COM, INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 3 PROPERTY AND EQUIPMENT

Property and Equipment

The major classes of property and equipment, including capital leases, are as follows (in thousands):

	As of	
	June 30, 2009	December 31, 2008
Software	$ 7,805	$ 7,441
Computers and equipment	10,969	10,340
Furniture and fixtures, machinery and equipment	46,511	47,146
Leasehold improvements	6,604	6,441
Construction in progress	7,243	2,056
	79,132	73,424
Less accumulated depreciation	(30,063)	(24,462)
Total property and equipment, net	$ 49,069	$ 48,962

Depreciation expense on property and equipment, including assets under loan obligations and capital leases, was $3.3 million and $2.5 million for the three months ended June 30, 2009 and 2008, respectively, and $6.3 million and $4.9 million for the six months ended June 30, 2009 and 2008, respectively. As of June 30, 2009, assets under capital leases totaled $9.6 million with accumulated depreciation of $3.5 million. As of December 31, 2008, assets under capital leases totaled $4.7 million with accumulated depreciation of $2.3 million.

Intangible Assets

Our intangible assets are comprised largely of purchased tradenames, customer relationship assets, and domain name assets. Amortization expense on intangible assets with definite lives was $0.2 million and $0.1 million for the three months ended June 30, 2009 and 2008, respectively and $0.3 million and $0.2 million for the six months ended June 30, 2009 and 2008, respectively.

NOTE 4 ACCRUED AND OTHER LIABILITIES

Accrued and other liabilities consist of the following (in thousands):

	As of	
	June 30, 2009	December 31, 2008

Accrued operating expenses	$ 27,801	$ 33,956
Accrued shipping expenses	8,999	8,858
Accrued payroll expenses	3,030	2,730
Deferred revenue	3,967	3,234
Gift certificate liability	3,032	2,019
Interest rate swap		510
Other accrued liabilities	9	102
Preferred stock warrant liability	29,626	
Total accrued and other liabilities	$ 76,464	$ 51,409

ZAPPOS.COM, INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)

We have amounts accrued in Accrued operating expenses related to potential property tax liabilities in the state of Kentucky. As of June 30, 2009, $1.0 million remains accrued for the period spanning 2006 through 2009.

During the fourth quarter of 2008, the Company discontinued operations in its Nevada and Bowling Green, Kentucky retail stores. The Company has recognized the fair value of the liabilities incurred for contract termination costs and one-time termination benefits associated with discontinuing those operations in accordance with FASB Statement No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*. As of December 31, 2008, the fair value of those liabilities was $3.2 million for contract termination costs and $0.1 million for one-time termination benefits, all of which were expensed during the fourth quarter of 2008. As of June 30, 2009, the fair value of those liabilities was $2.5 million for contract termination costs and $0.1 million for one-time termination benefits. The cumulative amount incurred to date is $3.9 million. Those costs are aggregated in Discontinued operations, net of tax in the Consolidated Statements of Operations. We did not incur any additional material costs during the first half of 2009, nor do we expect to incur additional material amounts in 2009.

The following is a reconciliation of changes in our liability for contract termination costs and one-time termination benefits during 2009 (in thousands):

	Contract Termination Costs	One-Time Termination Benefits
Balance at December 31, 2008	$ 3,246	$ 143
Costs incurred and charged to expense	96	
Costs paid or otherwise settled	(775)	(94)
Adjustments	(53)	
Balance at June 30, 2009	$ 2,514	$ 49

NOTE 5 OTHER LONG-TERM LIABILITIES

Other long-term liabilities consist of the following (in thousands):

	As of	
	June 30, 2009	December 31, 2008
Preferred stock warrant liability	$	$ 15,905
Notes Payable		250
FIN No. 48 liability	3,366	3,365
Asset retirement obligations	382	415
Total other long-term liabilities	$ 3,748	$ 19,935

For more information regarding the preferred stock warrant liability, refer to Note 9. For more information regarding the FASB Interpretation (FIN) No. 48, *Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109*, refer to Note 10.

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ZAPPOS.COM, INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following is a reconciliation of changes in our asset retirement obligation during 2009 (in thousands):

Balance at December 31, 2008	$ 415
Liabilities incurred	
Liabilities settled	
Accretion expense	35
Revisions in estimated cash flows	(68)
Balance at June 30, 2009	$ 382

NOTE 6 DEBT

Loan Obligations

The Company entered into a $20.0 million secured Term Loan Facility (Term Facility) on September 30, 2006. The Term Facility provides for certain events of default and sets forth a number of affirmative and negative covenants with which we must comply. Certain of these covenants include financial net profit and net worth covenants which are tested subject to minimum unused borrowing capacity guidelines. As of June 30, 2009, we were in compliance with such covenants. The balance of the term loan is due and payable on June 30, 2010. For more information regarding the Term Facility, refer to our annual report for the year ended December 31, 2008.

The Company also entered into a variety of loan obligations for equipment in the Kentucky fulfillment centers and accounting software. The loan obligations are secured by certain assets as provided in the respective loan agreements. The loan obligations consist of the following (in thousands):

	As of	
	June 30, 2009	**December 31, 2008**
$20 million Term Loan Facility; matures on June 30, 2010	$ 17,600	$ 18,800
$0.94 million Software Loan; matures on February 1, 2010 (interest is approximately 7.45% per annum)	256	418
$0.93 million Software Loan; matures on February 1, 2010 (interest is approximately 6.72% per annum)	271	444
$0.53 million Software Loan; matures on February 1, 2010 (interest is approximately 7.19% per annum)	155	254
$0.98 million Software Loan; matures on February 1, 2010 (interest is approximately 6.96% per annum)	310	508

$0.11 million Software Loan; matures on February 1, 2010 (interest is approximately 7.07% per annum)	39	64
$0.27 million Software Loan; matures on February 1, 2010 (interest is approximately 5.90% per annum)	91	152
Total loan obligations	18,722	20,640
Current portion of loan obligations	(18,722)	(4,863)
Loan obligations, noncurrent	$	$ 15,777

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ZAPPOS.COM, INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)

As of June 30, 2009, scheduled principal payments on our loan obligations are as follows (in thousands):

Years Ending December 31,	
2009	$ 2,945
2010	15,777
Total	$ 18,722

Capital Leases

The Company entered into capital leases obligations for equipment in the Kentucky fulfillment and its other facilities. The assets and liabilities under capital leases are recorded at the lower of the present value of the minimum payments or the fair value of the asset under the agreement. Payments under the capital leases are secured by the assets related to such agreements. The capital leases expire between 2009 and 2012. The future minimum payments under all noncancelable capital lease obligations as of June 30, 2009 are as follows (in thousands):

Years Ending December 31,	
2009	$ 1,693
2010	3,141
2011	2,290
2012	414
Total minimum payments	7,538
Less amounts representing interest	(758)
Present value of minimum payments	6,780
Less current portion	(3,046)
Long-term portion	$ 3,734

Revolving Line of Credit

Zappos has a revolving line of credit agreement with its lenders pursuant to the terms of a revolving credit and security agreement dated January 23, 2006, as amended (the Line of Credit Agreement). As of June 30, 2009, the unused borrowing capacity after reserves on the facility was $34.2 million. The maximum commitment from our lenders is $100.0 million, subject to available collateral, which is calculated based, in part, on the carrying value of our inventory. The weighted-average interest rate on the Line of Credit Agreement for the three months ended June 30, 2009 and 2008 was 2.3% and 4.3%, respectively, and for the six months ended June 30, 2009 and 2008, it was 2.3% and 5.6%, respectively. The line of credit expires on September 30, 2010 and may be repayable at Wells Fargo s discretion in the event of a default or if a material adverse

effect in our business has occurred. As of June 30, 2009, we were in compliance with our minimum liquidity covenant.

NOTE 7 DERIVATIVE FINANCIAL INSTRUMENTS

Interest Rate Swap

In 2005, Zappos entered into a swap agreement that effectively fixes the interest rate for up to $24.0 million of our revolving line of credit. We recognized changes to the fair value of the interest rate swap which resulted in a benefit of $0.3 million and a benefit of $0.3 million for the three months ended June 30, 2009 and 2008, respectively, and a benefit of $0.5 million and an expense of $0.1 million for the six months ended June 30, 2009 and 2008, respectively. The change was recorded as a component of Other interest expense. The swap agreement expired on June 30, 2009.

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ZAPPOS.COM, INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Because the interest rate swap is measured at fair value on a recurring basis, the measurement is subject to the provisions of FASB Statement No. 157, *Fair Value Measurements* (FASB Statement 157). The fair value measurement of the interest rate swap falls within Level 2 of the fair value hierarchy, which was established in FASB Statement 157, because it is based on the LIBOR swap rate, which is observable. The fair value of the interest rate swap was $0 and a liability of $0.5 million as of June 30, 2009 and 2008, respectively.

NOTE 8 STOCKHOLDERS EQUITY

As of June 30, 2009, our capital stock consists of the following (in thousands):

	Shares		Liquidation
	Authorized	Outstanding	Preference
Series A preferred stock	1,550	1,491	$ 149
Series B preferred stock	7,725	4,514	880
Series C preferred stock	17,300	15,796	7,151
Series D preferred stock	650	428	338
Series E preferred stock	5,000	3,247	80,000
Series F preferred stock	3,772	3,772	92,948
Total Preferred Stock	35,997	29,248	$ 181,466
Common	60,000	15,970	$
Total Common Stock	60,000	15,970	$

NOTE 9 STOCK OPTIONS AND WARRANTS

Stock Option Plan

Stock-based compensation expense for the period is presented below (in thousands):

	For the three months ended June 30,		For the six months ended June 30,	
	2009	2008	2009	2008
Sales, marketing, and fulfillment	$ 80	$ 44	$ 158	$ 89
General and administrative	503	447	951	875
Product development	293	171	600	319
Total earned stock-based compensation	$ 876	$ 662	$ 1,709	$ 1,283

For the three months ended June 30, 2009, there were 0.1 million options exercised with a total intrinsic value of $0.1 million. For the six months ended June 30, 2009, there were

0.1 million options exercised with a total intrinsic value of $0.6 million. A summary of stock option activity as of June 30, 2009, and changes during the three and six months then ended is presented below (amounts in thousands):

	Shares
Balance at December 31, 2008	4,824
Options granted	619
Options exercised	(58)
Options canceled/forfeited	(26)
Balance at June 30, 2009	5,359

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ZAPPOS.COM, INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Warrant

As of June 30, 2009, the warrant for 2.6 million shares of Series B convertible preferred stock remains outstanding.

The calculation of fair value of the warrant requires the input of highly subjective assumptions and changes in those assumptions could materially affect the fair value estimates. The Company will continue to adjust the warrant liability for changes in fair value until the earlier of the exercise of the warrants or the completion of a liquidation event, including the completion of an initial public offering, at which time the liability will be reclassified to stockholders equity.

The Company estimated the fair value of the warrant using the Black-Scholes option-pricing model. The assumptions used in the model to value the warrant were as follows:

	For the six months ended June 30,	
	2009	**2008**
Remaining contractual term	0.5 - 1.0 years	1.5 - 2.0 years
Blended risk-free interest rate	0.4% - 0.7%	1.6% - 2.5%
Expected volatility	60.0% - 69.5%	60%
Expected dividend yield	0%	0%

The fair value of the underlying preferred shares was assessed in accordance with AICPA Technical Practice Aid, Valuation of Privately-Held Company Equity Securities Issued as Compensation (2004).

Because the warrant is measured at fair value on a recurring basis, the measurement is subject to the provisions of FASB Statement 157. The measurement of the warrant falls under Level 3 of the fair value measurement hierarchy. The fair value of the warrant as of June 30, 2009 and December 31, 2008 was $29.6 million and $15.9 million, respectively. We recognized changes to the fair value of the warrant which resulted in an expense of $12.4 million and an expense of $5.8 million for the three months ended June 30, 2009 and 2008, respectively. We recognized changes to the fair value of the warrant which resulted in an expense of $13.7 million and an expense of $5.7 million for the six months ended June 30, 2009 and 2008, respectively. The change was recorded as a component of Interest benefit (expense) associated with preferred stock warrant .

The following table illustrates a reconciliation of the beginning and ending balances of items measured under Level 3 of the fair value measurement hierarchy of FASB Statement 157. Currently the warrant is the only item measured under this level (in thousands):

	Fair Value Measurements Using Significant Unobservable Inputs (Level 3)

	Warrant	Total
Beginning balance at December 31, 2008	$ 15,905	$ 15,905
Total losses included in earnings	13,721	13,721
Purchases, issuance, and settlements		
Transfers in and/or out of Level 3		
Ending balance at June 30, 2009	$ 29,626	$ 29,626

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ZAPPOS.COM, INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)

NOTE 10 INCOME TAXES

As of June 30, 2009, we had federal net operating loss carryforwards of approximately $0.8 million, which if unused will expire between 2014 through 2022. We also had state (California) net operating loss carryforwards of approximately $4.1 million, which if unused will expire between 2010 through 2013. Currently there is a valuation allowance on the Deferred Tax Asset for $0.2 million. This allowance relates to California Net Operating Losses that the Company may not be able to realize in the future. The use of certain net operating loss carryforwards is subject to annual limitations based on ownership changes of our stock, as defined by Section 382 of the Internal Revenue Code and Section 24416 of the California Revenue and Taxation Code. The annual limitations may result in the expiration of the net operating loss before utilization.

Our tax provision for interim periods is determined using an estimate of our annual effective tax rate in addition to projected income for the fiscal year. Our total cash payments are limited as we have deferred tax assets related to our net operating loss carryforwards (NOLs), which we are able to utilize to reduce our taxable income. The annual use of our NOLs is subject to limitations under Section 382 of the Internal Revenue Code related to ownership changes.

We file tax returns as prescribed by the laws of the jurisdictions in which we operate. We are subject to U.S. income tax examinations for the years 1999 through 2007 as NOLs from 1999 through 2002 have been utilized on later returns. Our federal income tax returns are currently under examination for the years ended December 31, 2006 and 2005.

NOTE 11 COMMITMENTS AND CONTINGENCIES

Legal Proceedings

The Company is involved in various litigation incidental to its business. The Company has evaluated such litigation in accordance with FASB Statement No. 5, *Accounting for Contingencies*, and determined that any losses resulting from it are not probable to result in material losses. However, the Company may incur substantial expenses and devote substantial time to defend itself against claims whether or not such claims are meritorious. In the event of a determination adverse to the Company, the Company may incur substantial monetary liability.

Operating Leases

Zappos has entered into operating leases for fulfillment centers, office space, retail stores, and computer equipment. The future minimum lease payments under all noncancelable leases as of June 30, 2009 are as follows (in thousands):

Years Ending December 31,	
2009	$ 3,515
2010	4,221

2011	4,303
2012	4,318
2013	4,318
Thereafter	7,687
Total minimum payments	$ 28,362

Rental expenses were $1.8 million and $1.8 million for the three months ended June 30, 2009 and 2008, respectively, and $3.6 million and $3.4 million for the six months ended June 30, 2009 and 2008, respectively.

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ZAPPOS.COM, INC.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Advertising and Media Commitments

As of June 30, 2009, the Company was contractually committed for the purchase of future advertising totaling approximately $3.3 million through 2010.

Contractual Commitments

As of June 30, 2009, the Company was contractually committed for the purchase of future capital assets and other services totaling approximately $8.5 million through 2010.

NOTE 12 SUBSEQUENT EVENTS

In July 2009, we signed an agreement to be acquired by Amazon.com, Inc. Under the terms of the agreement, Amazon.com, Inc. will acquire all of our outstanding shares and assume all outstanding options, warrants, and debt in exchange for approximately 10 million shares of Amazon.com, Inc. common stock, equal to approximately $807.0 million based on the average closing price for the 45 trading days ending July 17, 2009. Subject to various closing conditions, including certain regulatory approvals, the acquisition is expected to close during the fall of 2009.

In July 2009, we entered into a number of leasing agreements to extend current leases at our corporate headquarters in Henderson, NV. The agreements have terms of 5 years during which we will pay approximately $8.3 million through 2014.

In July 2009, we entered into an agreement with Kiva Systems, Inc. to purchase additional Kiva units for our Kentucky fulfillment center. The purchase price is approximately $0.7 million.

In accordance with FASB Statement 165, we have evaluated subsequent events through the date and time these consolidated financial statements were issued on September 11, 2009.

NOTE 13 OUT-OF-PERIOD ADJUSTMENTS

The results for the second quarter of 2009 include out-of-period adjustments of $0.2 million to net revenues and $(1.1) million to cost of revenues. After income taxes, the net impact of those adjustments was a benefit of $0.8 million. The adjustments were primarily the result of a system error that was discovered in the third quarter and impacted the second, third, and fourth quarters of 2008 as well as the first quarter of 2009. The net effect of these adjustments on the results before tax was to increase the profit or reduce the loss by between $0.2 million to $0.4 million for each affected quarter. The adjustments had no impact on cash flow and the impact on gross margin was immaterial.

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PART II

INFORMATION NOT REQUIRED IN THE PROSPECTUS

Item 20. Indemnification of Directors and Officers

Section 145 of the Delaware General Corporation Law (the DGCL) provides that a corporation may indemnify its directors and officers, as well as other employees and individuals, against expenses (including attorneys fees), judgments, fines and amounts paid in settlement in connection with specified actions, suits or proceedings, whether civil, criminal, administrative or investigative (other than an action by or in the right of the corporation a derivative action), if they acted in good faith and in a manner they reasonably believed to be in or not opposed to the best interests of the corporation, and, with respect to any criminal action or proceeding, had no reasonable cause to believe their conduct was unlawful. A similar standard is applicable in the case of derivative actions, except that indemnification only extends to expenses (including attorneys fees) incurred in connection with the defense or settlement of such actions, and the statute requires court approval before there can be any indemnification in which the person seeking indemnification has been found liable to the corporation. The statute provides that it is not exclusive of other indemnification that may be granted by a corporation s bylaws, disinterested director vote, stockholder vote, agreement or otherwise.

Section 10 of the registrant s Amended and Restated Bylaws requires indemnification to the full extent permitted under Delaware law as it now exists or may hereafter be amended. Subject to any restrictions imposed by Delaware law, the Bylaws provide an unconditional right to indemnification for all expense, liability and loss (including attorneys fees, judgments, fines, ERISA excise taxes or penalties and amounts paid in settlement) actually and reasonably incurred or suffered by any person in connection with any actual or threatened action, suit or proceeding, whether civil, criminal, administrative or investigative by reason of the fact that such person is or was serving as a director or officer of the registrant or that, being or having been a director or officer of the registrant, such person is or was serving at the request of the registrant as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise, including service with respect to an employee benefit plan.

The Bylaws also provide that the registrant may, by action of its Board of Directors, provide indemnification to its employees and agents with the same scope and effect as the foregoing indemnification of directors and officers.

Section 102(b)(7) of the DGCL permits a corporation to provide in its certificate of incorporation that a director of the corporation shall not be personally liable to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, except for liability for (i) any breach of the director s duty of loyalty to the corporation or its stockholders, (ii) acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law, (iii) payments of unlawful dividends or unlawful stock repurchases or redemptions, or (iv) any transaction from which the director derived an improper personal benefit.

Article 10 of the registrant s Restated Certificate of Incorporation provides that to the full extent that the DGCL, as it now exists or may hereafter be amended, permits the limitation or elimination of the liability of directors, a director of the registrant shall not be liable to the registrant or its stockholders for monetary damages for breach of fiduciary duty as a director. Any amendment to or repeal of such Article 10 shall not adversely affect any right or protection of a director of the registrant for or with respect to any acts or omissions of such director occurring prior to such amendment or repeal.

The registrant has entered into certain indemnification agreements with its directors. The indemnification agreements provide the registrant s directors with further indemnification, to the maximum extent permitted by the DGCL.

The foregoing summaries are necessarily subject to the complete text of the statute, the registrant s Restated Certificate of Incorporation and Amended and Restated Bylaws, and the arrangements referred to above and are qualified in their entirety by reference thereto.

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Item 21. Exhibits and Financial Statement Schedules

Exhibit Number	Description
2.1	Agreement and Plan of Merger, dated July 22, 2009, among Amazon.com, Inc., Zeta Acquisition, Inc., Zappos.com, Inc., and Alfred Lin (included as Appendix A to this consent solicitation/prospectus filed as part of this Amendment No. 1 to the Registration Statement).
3.1	Restated Certificate of Incorporation of Amazon.com, Inc. (incorporated by reference to Amazon.com, Inc. s Quarterly Report on Form 10-Q for the Quarter ended March 31, 2000).
3.2	Amended and Restated Bylaws of Amazon.com, Inc. (incorporated by reference to Amazon.com, Inc. s Current Report on Form 8-K, dated February 18, 2009).
5.1	Opinion of Gibson, Dunn & Crutcher LLP regarding the legality of the shares to be issued (including consent).*
8.1	Form of Opinion of Gibson, Dunn & Crutcher LLP regarding certain tax matters (including consent).**
8.2	Form of Opinion of Fenwick & West LLP regarding certain tax matters (including consent).**
10.1	Form of Retention Agreement.**
15.1	Letter from PricewaterhouseCoopers LLP regarding unaudited interim financial information.**
21.1	List of Significant Subsidiaries (incorporated by reference to Amazon.com, Inc. s Annual Report on Form 10-K for the Fiscal Year Ended December 31, 2008).
23.1	Consent of Ernst & Young LLP, Independent Registered Public Accounting Firm.**
23.2	Consent of PricewaterhouseCoopers LLP, Independent Accountants.**
23.3	Consent of Gibson, Dunn & Crutcher LLP (included in Exhibits 5.1 and 8.1).
23.4	Consent of Fenwick & West LLP (included in Exhibit 8.2).
23.5	Consent of Morgan Stanley & Co. Incorporated.**
24.1	Power of Attorney. *
99.1	Form of Consent for holders of Zappos.com, Inc. common stock.**
99.2	Form of Consent for holders of Zappos.com, Inc. Series A and/or Series B and/or Series C and/or Series D preferred stock.**
99.3	Form of Consent for holders of Zappos.com, Inc. Series E and/or Series F preferred stock.**

* Previously filed.
** Filed herewith
Amazon will furnish to the Commission, upon request, a copy of each schedule or exhibit to the Agreement.

Item 22. Undertakings.
Amazon hereby undertakes:

(a) To file, during any period in which offers or sales are being made, a post-effective amendment to this Registration Statement:

(i) To include any prospectus required by section 10(a)(3) of the Securities Act;

(ii) To reflect in the prospectus any facts or events arising after the effective date of the Registration Statement (or the most recent post-effective amendment thereof) which, individually or in the aggregate, represent a fundamental change in the information set forth in the Registration Statement. Notwithstanding the foregoing, any increase or decrease in volume of securities offered (if

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the total dollar value of securities offered would not exceed that which was registered) and any deviation from the low or high end of the estimated maximum offering range may be reflected in the form of prospectus filed with the Commission pursuant to Rule 424(b) if, in the aggregate, the changes in volume and price represent no more than a 20% change in the maximum aggregate offering price set forth in the Calculation of Registration Fee table in the effective Registration Statement, and;

(iii) To include any material information with respect to the plan of distribution not previously disclosed in the Registration Statement or any material change to such information in the Registration Statement.

(b) That, for the purpose of determining any liability under the Securities Act of 1933, as amended, each such post-effective amendment shall be deemed to be a new registration statement relating to the securities offered therein, and the offering of such securities at that time shall be deemed to be the initial bona fide offering thereof.

(c) To remove from registration by means of a post-effective amendment any of the securities being registered which remain unsold at the termination of the offering.

(d) That, for the purpose of determining liability under the Securities Act to any purchaser, each prospectus filed pursuant to Rule 424(b) as part of a Registration Statement relating to an offering, other than Registration Statements relying on Rule 430B or other than prospectuses filed in reliance on Rule 430A, shall be deemed to be part of and included in the Registration Statement as of the date it is first used after effectiveness; *provided, however*, that no statement made in a Registration Statement or prospectus that is part of the Registration Statement or made in a document incorporated or deemed incorporated by reference into the Registration Statement or prospectus that is part of the Registration Statement will, as to a purchaser with a time of contract of sale prior to such first use, supersede or modify any statement that was made in the Registration Statement or prospectus that was part of the Registration Statement or made in any such document immediately prior to such date of first use.

(e) That, for the purpose of determining liability of Amazon under the Securities Act to any purchaser in the initial distribution of the securities, Amazon undertakes that in a primary offering of securities of Amazon pursuant to this Registration Statement, regardless of the underwriting method used to sell the securities to the purchaser, if the securities are offered or sold to such purchaser by means of any of the following communications, Amazon will be a seller to the purchaser and will be considered to offer or sell such securities to such purchaser:

(i) Any preliminary prospectus or prospectus of Amazon relating to the offering required to be filed pursuant to Rule 424;

(ii) Any free writing prospectus relating to the offering prepared by or on behalf of Amazon or used or referred to by Amazon;

(iii) The portion of any other free writing prospectus relating to the offering containing material information about Amazon or its securities provided by or on behalf of Amazon; and

(iv) Any other communication that is an offer in the offering made by Amazon to the purchaser.

Amazon hereby undertakes that, for purposes of determining any liability under the Securities Act of 1933, as amended, each filing of Amazon s annual report pursuant to Section 13(a) or Section 15(d) of the Securities Exchange Act of 1934 that is

incorporated by reference in the Registration Statement shall be deemed to be a new registration statement relating to the securities offered therein, and the offering of such securities at that time shall be deemed to be the initial bona fide offering thereof.

Amazon hereby undertakes:

(a) that prior to any public reoffering of the securities registered hereunder through use of a prospectus which is a part of this Registration Statement, by any person or party who is deemed to be an underwriter

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within the meaning of Rule 145(c), the issuer undertakes that such reoffering prospectus will contain the information called for by the applicable registration form with respect to reofferings by persons who may be deemed underwriters, in addition to the information called for by the other Items of the applicable form; and

(b) that every prospectus (i) that is filed pursuant to the immediately preceding paragraph, or (ii) that purports to meet the requirements of Section 10(a)(3) of the Securities Act of 1933, as amended, and is used in connection with an offering of securities subject to Rule 415, will be filed as a part of an amendment to the registration statement and will not be used until such amendment is effective, and that, for purposes of determining any liability under the Securities Act of 1933, as amended, each such post-effective amendment shall be deemed to be a new registration statement relating to the securities offered therein, and the offering of such securities at that time shall be deemed to be the initial bona fide offering thereof.

Amazon hereby undertakes to respond to requests for information that is incorporated by reference into the prospectus pursuant to Items 4, 10(b), 11, or 13 of Form S-4, within one business day of receipt of such request, and to send the incorporated documents by first class mail or other equally prompt means. This includes information contained in documents filed subsequent to the effective date of the Registration Statement through the date of responding to the request.

Amazon hereby undertakes to supply by means of a post-effective amendment all information concerning a transaction, and the company being acquired involved therein, that was not the subject of and included in the Registration Statement when it became effective.

Insofar as indemnification for liabilities arising under the Securities Act may be permitted to directors, officers and controlling persons of Amazon pursuant to the foregoing provisions, Amazon has been informed that in the opinion of the SEC such indemnification is against public policy as expressed in the Securities Act and is, therefore, unenforceable. In the event that a claim for indemnification against such liabilities (other than the payment by Amazon of expenses incurred or paid by a director, officer or controlling person of Amazon in the successful defense of any action, suit or proceeding) is asserted by such director, officer or controlling person in connection with the securities being registered, Amazon will, unless in the opinion of its counsel the matter has been settled by controlling precedent, submit to a court of appropriate jurisdiction the question whether such indemnification by it is against public policy as expressed in the Securities Act and will be governed by the final adjudication of such issue.

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SIGNATURES

Pursuant to the requirements of the Securities Act of 1933, the Registrant has duly caused this Amendment No. 1 to the Registration Statement to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of Seattle, State of Washington, on September 14, 2009.

AMAZON.COM, INC.

By: /s/ THOMAS J. SZKUTAK
Thomas J. Szkutak,

Senior Vice President

and Chief Financial Officer

(Principal Financial Officer)

Pursuant to the requirements of the Securities Act of 1933, this Amendment No. 1 to the Registration Statement has been signed by the following persons in the capacities and on the date indicated.

* **Jeffrey P. Bezos,** **Chairman of the Board of Directors, President and Chief Executive Officer** **(Principal Executive Officer)**	Date: September 14, 2009	* **L. John Doerr,** **Director**	Date: September 14, 2009
* **Thomas J. Szkutak,** **Senior Vice President and Chief Financial Officer** **(Principal Financial Officer)**	Date: September 14, 2009	* **William B. Gordon,** **Director**	Date: September 14, 2009
* **Shelley L. Reynolds,** **Vice President, Worldwide Controller** **(Principal Accounting Officer)**	Date: September 14, 2009	* **Alain Monié,** **Director**	Date: September 14, 2009
* **Tom A. Alberg,** **Director**	Date: September 14, 2009	* **Thomas O. Ryder,** **Director**	Date: September 14, 2009
* **John Seely Brown,**	Date: September 14, 2009	* **Patricia Q. Stonesifer,**	Date: September 14, 2009

Director	**Director**

* The undersigned does hereby sign this Amendment No. 1 to the Registration Statement on behalf of the above-indicated director or officer of Amazon.com, Inc. pursuant to a power of attorney executed by such director or officer.

/s/ THOMAS J. SZKUTAK
Thomas J. Szkutak

Attorney-in-Fact

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