

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-K

(Mark one)

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

FOR THE FISCAL YEAR ENDED DECEMBER 30, 2000

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

For the transition period from _____ to _____.

COMMISSION FILE NO. 0-25121

SELECT COMFORT CORPORATION
(Exact name of registrant as specified in its charter)

MINNESOTA
(State or other jurisdiction of
incorporation or organization)

41-1597886
(I.R.S. Employer
Identification No.)

6105 TRENTON LANE NORTH
MINNEAPOLIS, MINNESOTA
(Address of principal executive offices)

55442
(Zip code)

Registrant's telephone number, including area code: (763) 551-7000

Securities registered pursuant to Section 12(b) of the Act: NONE

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

COMMON STOCK, \$.01 PAR VALUE

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

Indicate by check mark 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.

As of March 28, 2001, 18,055,633 shares of Common Stock of the Registrant were outstanding, and the aggregate market value of the Common Stock of the Registrant as of that date (based upon the last reported sale price of the Common Stock at that date as reported by the Nasdaq National Market System), excluding outstanding shares beneficially owned by directors and executive officers, was \$16,500,517.

DOCUMENTS INCORPORATED BY REFERENCE

Part III of this Annual Report on Form 10-K incorporates by reference information (to the extent specific sections are referred to herein) from the Registrant's Proxy Statement for its 2001 Annual Meeting (the "2001 Proxy Statement").

TABLE OF CONTENTS

PART I.....2

ITEM 1. BUSINESS.....	2
General.....	2
Business and Growth Strategy.....	2
Products.....	5
Retail Stores.....	6
Direct Marketing Operations.....	7
E-Commerce.....	8
Marketing and Advertising.....	9

Consumer Education and Customer Service.....	10
Manufacturing and Distribution.....	10
Suppliers.....	11
Intellectual Property.....	11
Competition.....	11
Consumer Credit Arrangements.....	12
Governmental Regulation.....	12
Employees.....	12
Certain Risk Factors.....	13
ITEM 2. PROPERTIES.....	20
ITEM 3. LEGAL PROCEEDINGS.....	20
ITEM 4A. EXECUTIVE OFFICERS OF THE COMPANY.....	22
PART II.....	21
ITEM 5. MARKET FOR THE REGISTRANT'S COMMON STOCK AND RELATED SHAREHOLDER MATTERS.....	23
Number of Record Holders; Dividends.....	24
Use of Proceeds from Initial Public Offering.....	24
ITEM 6. SELECTED FINANCIAL DATA.....	25
ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.....	26
ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK.....	32
ITEM 8. FIANCIAL STATEMENTS AND SUPPLEMENTARY DATA.....	32
ITEM 9. CHANGES AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE.....	32

PART III.....	30
ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT.....	33
Directors, Executive Officers, Promoters and Control Persons.....	33
Section 16(a) Beneficial Ownership Reporting Compliance.....	33
ITEM 11. EXECUTIVE COMPENSATION.....	33
ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT.....	33
ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS.....	33
PART IV.....	34
ITEM 14. EXHIBITS, FINANCIAL STATEMENT SCHEDULES AND REPORTS ON FORM 8-K.....	34
Index to Consolidated Financial Statements.....	31
Index to Consolidated Financial Statement Schedules.....	31
Exhibits.....	32
Reports on Form 8-K.....	33

Our fiscal year ends on the Saturday closest to December 31, and unless the context otherwise requires, all references to years in this Form 10-K refer to our fiscal years. All references to "Select Comfort," "the Company," "we" or "us" herein include our wholly owned subsidiaries, Select Comfort Direct Corporation, Select Comfort Retail Corporation, Direct Call Centers, Inc., Select Comfort SC Corporation and selectcomfort.com corporation.

Select Comfort(R), Sleep Number(R), Comfort Club(R), Sleep Better on Air(R), Sleep Insurance(R), The Sleep Number Bed by Select Comfort(TM) The Sleep Number Store by Select Comfort(TM), Firmness Control System(TM), Select Comfort Sofa Sleepaire(TM), Select Comfort Sofa Sleepaire Collection(TM) and the Company's stylized logos are trademarks and/or service marks of the Company.

PART I

This Form 10-K contains certain forward-looking statements. For this purpose, any statements contained in this Form 10-K that are not statements of historical fact may be deemed to be forward-looking statements. Without limiting the foregoing, words such as "may," "will," "expect," "believe," "anticipate," "estimate" or "continue" or comparable terminology are intended to identify forward-looking statements. These statements by their nature involve substantial risks and uncertainties, and actual results may differ materially depending on a variety of factors, including those set forth under the heading below entitled "Certain Risk Factors."

ITEM 1. BUSINESS

GENERAL

Select Comfort is the leading manufacturer, specialty retailer and direct marketer of premium quality, innovative adjustable-firmness beds and other sleep-related products. We believe we are revolutionizing the mattress industry by offering a differentiated product through a variety of service-oriented distribution channels.

Our products address broad-based consumer sleep problems, resulting in a better night's sleep. In comparison with traditional mattress products, our proprietary Sleep Number beds utilize adjustable air chamber technology to more naturally contour to the body, thereby generally providing:

- - better spinal alignment,
- - reduced pressure points,
- - greater relief of lower back pain,
- - greater overall comfort, and
- - better quality sleep.

Our Firmness Control System allows customers to independently customize each side of the Sleep Number bed to their ideal level of firmness, comfort and support.

Unlike traditional mattress manufacturers, we have historically sold our products directly to consumers through three controlled, complementary and service-oriented distribution channels:

- - RETAIL, including company-operated retail stores and leased departments within larger retail stores,
- - DIRECT MARKETING, including a company-operated call center, and
- - E-COMMERCE, through our Web site at selectcomfort.com.

In 2000, we began to develop wholesale relationships with a leading home furnishings retailer and with the QVC shopping channel.

At December 30, 2000, our retail operations included 333 stores in 45 states, including 25 leased departments within larger retail stores.

Select Comfort was incorporated in Minnesota in February 1987. Our principal executive office is located at 6105 Trenton Lane North, Minneapolis, Minnesota 55442. Our telephone number is (763) 551-7000.

BUSINESS AND GROWTH STRATEGY

Following the arrival of William R. McLaughlin as the Company's new President and CEO at the end of the first quarter of fiscal 2000, we have focused on five primary strategic priorities: (i) building consumer awareness, (ii) rightsizing our cost structure, (iii) improving our sales conversion effectiveness, (iv) pursuing alternative distribution channels, and (v) continuously improving product quality, innovation and service levels. Each of these

strategic priorities is discussed in greater detail below.

BUILDING AWARENESS. Lack of awareness among the broad consumer audience of our brand, product benefits and store locations has been our most significant barrier to growth. Though we have incurred significant cumulative advertising spending over the last few years, and we have a large customer base and extraordinary customer satisfaction ratings and referrals, we have had relatively low levels of consumer awareness of our brand, product benefits and store locations. We generally see a close correlation between consumer awareness levels in a market (due to factors such as the length of our presence in the market, our cumulative advertising spending, store density per population and word-of-mouth referrals) and our share of overall mattress sales in the market. As a result, our current marketing efforts are focused on increasing consumer awareness through appealing to a broader demographic audience with advertising and other marketing programs that showcase the unique features and benefits of our product.

Historically, our marketing personnel had been spread across our various sales channels. Early in 2000, we laid the groundwork for developing integrated, consistent and efficient marketing messages by consolidating our marketing personnel into one organization.

In mid-2000, we renewed our relationship with New York-based advertising agency Messner Vetere Berger McNamee Schmetterer/Euro RSCG to help us design and implement a breakthrough brand and marketing program. In the second half of 2000, working with this agency, the marketing team focused its efforts on the repositioning of our product, brand and marketing messages around our Sleep Number bed. Our Sleep Number campaign focuses on the unique features and benefits of our product: individualized and adjustable firmness, comfort and support to provide a perfect nights sleep. This message has broader appeal than many of our traditional marketing messages, is being delivered through the broader reach of prime time TV in selected markets, and is targeted at a broader demographic audience. We launched our Sleep Number campaign in two pilot markets in January 2001 and in six of our largest markets in February 2001, with encouraging initial results. See "-Marketing and Advertising."

RIGHTSIZING OUR COST STRUCTURE. In 2000, we began to implement initiatives to bring our cost structure in line with our sales volumes, with the ultimate objective of making our core bed business profitable at 2000 sales volumes and to enable funding of awareness building marketing programs. Specific actions taken to improve our cost structure include:

- - Termination of non-core business initiatives, including catalog, road show and event marketing, and expenses related to investment in the initial launch of the sofa sleeper product line and relaunch of the Company's web site,
- - Rebalancing of manufacturing between our three plant locations,
- - Selling expense savings from reducing our sales infrastructure by closing 27 under-performing retail stores and our direct call center in South Carolina, and by streamlining retail management and store staffing levels,
- - Corporate general and administrative expense savings from reductions in corporate staff and consolidating our two Minneapolis offices,
- - Logistics cost savings from systems and packaging improvements to enable shipping with Fed Ex as well as UPS,
- - Product cost reductions with equal or superior quality and reduced product returns, and
- - Promotional discount reductions through improved program design and controls.

In 2001, we are continuing to aggressively pursue additional cost saving opportunities. In April of 2001, we ceased manufacturing in our Minneapolis, Minnesota, plant. This plant will continue to function as a center for processing returns and warranty and replacement parts, and as a cross-dock for regional distribution. We reduced our workforce by 76 positions in April 2001 from the cessation of manufacturing in Minneapolis and from unrelated reductions in our corporate staff.

IMPROVING SALES CONVERSION. To improve the effectiveness of our sales conversion process, we have developed and are implementing a variety of initiatives, including:

- - awareness building programs that are designed to drive more knowledgeable and motivated consumers to our points of distribution,
- - a simplified and close-oriented selling process focused on the unique features and benefits of our product and the value proposition that our product delivers,
- - enhancement of the consumer's in-store experience through the use of tools that better demonstrate the benefits of our products,
- - improvements in the appearance of our products,
- - changes in our direct marketing call center strategy to drive more traffic to our retail stores,
- - offering different and more creative financing alternatives for our customers,
- - expanding our home delivery, assembly and mattress removal capability to additional markets,
- - compensation and incentive plans that are more highly commission-driven and close-oriented, and
- - changes in our promotional schedule to better leverage key consumer shopping dates.

ALTERNATIVE DISTRIBUTION CHANNELS. An important element of our growth strategy is to increase opportunities for consumers to become aware of, and to purchase, our products. In 2000, we tested two additional avenues for awareness and distribution.

In September 2000, we established our first wholesaling relationship with Gabberts, a leading home furnishings retailer in Minneapolis/St. Paul and Dallas metropolitan areas. In 2001, we are seeking to expand our relationship with Gabberts and to develop similar wholesaling relationships with other leading home furnishings retailers in additional markets. We believe that these relationships may enable us to leverage our advertising spending in key markets.

In October 2000, we tested the offering of our products on the QVC television shopping channel with a one hour program. This successful test led to an additional one-hour program in December 2000 and three hours in early March of 2001, each of which resulted in sales exceeding our expectations. We plan to expand our relationship with QVC in 2001, which we believe will increase overall consumer awareness of our product and brand in addition to providing an important sales channel.

INNOVATION AND CONTINUOUS PRODUCT LINE AND SERVICE LEVEL IMPROVEMENT. We believe that our future success will depend in part on our ability to continue to lead the mattress industry in innovation and to continue to improve our product line and service levels. In 2000, we reinvigorated our research and development capability to focus on continuous product improvements to deliver:

- - new and enhanced consumer benefits,

- - improved product quality, and
- - reduced product or delivery costs.

In the second half of 2000, we introduced our new line of foundations that provide both new and enhanced consumer benefits over the previous generation of foundations, as well as reduced product delivery costs. In addition, we have recently introduced new ticking for improved appearance of our Classic and Elite models.

In November 2000, we acquired the assets of SleepTec, Inc., the innovator and manufacturer of our sofa sleeper product. Until April 2001, we have been devoting a portion of our product development resources to improving the features, benefits and quality of this product line for a relaunch in the second half of 2001. In April 2001, consistent with our cost reduction efforts and in order to focus our resources on our core product line, we delayed the relaunch of this product line beyond 2001.

We have taken initial steps toward providing in-home delivery, assembly and mattress removal throughout the continental United States. To date, in-home delivery and assembly has been provided through our retail channel and is currently provided in connection with approximately 6% of our sales. We began testing mattress removal during the fourth quarter of 2000 and expect to offer this service in additional markets in 2001.

PRODUCTS

BEDS. Select Comfort offers four different Sleep Number bed models. Each bed comes in standard mattress sizes, ranging from twin to California king, as well as a waterbed replacement model. In addition, all Sleep Number beds feature a patented single- or dual-air chamber. The dual chamber allows each side of the mattress to be adjusted independently with the Firmness Control System for personalized comfort and support.

Our Imperial and Ultra Series of mattresses feature a patented wireless remote control with a digital display of the user's Sleep Number, which reflects the level of firmness and allows the consumer to easily adjust and readjust the firmness level to their personal preference. This feature is also available with our Classic and Elite Series of beds for an additional charge.

The air chambers of a Sleep Number bed are surrounded on all sides by a high-density foam perimeter to provide strong edge support. For added comfort, we offer a plush pillowtop option with an extra cushion of support designed to cradle the body. All Sleep Number mattresses are enclosed by comfortable, durable Belgian Damask covering which combines cotton and/or rayon for comfort and durability.

The contouring and support of a Sleep Number mattress works best with a specially designed foundation from Select Comfort. Used in place of a box spring, this durable foundation is uniquely designed to complement the air chambers and maintain a consistent support surface for the life of the bed. It is designed with interlocking panels for maximum structural integrity, as well as high-density polymer side panels and lateral support beams for additional support. And unlike traditional box springs, the foundation can be easily moved around corners and up and down stairs. The Select Comfort foundation is made of 100 percent recyclable material.

Sleep Number beds can be quickly assembled by customers through a simple tool-free process. Furthermore, because air is the primary support material of the mattress, Sleep Number beds do not lose their shape or support over time like traditional mattresses and box springs. Each bed is accompanied with instructional product brochures and easy-to-follow assembly instructions, is certified by Underwriter's Laboratories and is backed by a 20-year limited warranty and our 30 Night Trial and Better Night's Sleep Guarantee. We have historically offered our customers a 90-night in-home trial period under which the customer may return the bed within the first 90 days for a refund. The

customer is obligated to pay the return shipping charge. Effective May 29, 2001, we plan to shorten our in-home trial period to 30 days.

ACCESSORY PRODUCTS. In addition to mattresses and matching foundations, we offer a line of accessory products, including bed frames and a line of high quality mattress pads and specialty pillows, all designed to provide superior comfort and better quality sleep.

SOFA SLEEPERS. In 2000, we introduced a line of sofa sleepers with air-supported mattresses in select markets. This product offers significant advantages over traditional sofa sleeper products, including an 11-inch thick air supported mattress that provides all the benefits of adjustable and individualized comfort, firmness and support. In November 2000, we acquired the assets of SleepTec, Inc., the innovator and manufacturer of our sofa sleeper product. Until April 2001, we have been devoting a portion of our product development resources to improving the features, benefits and quality of this product line for a relaunch in the second half of 2001. In April 2001, consistent with our cost reduction efforts and in order to focus our resources on our core product line, we delayed the relaunch of this product line beyond 2001.

PRODUCT ENGINEERING. We maintain an active engineering department that continuously seeks to enhance our knowledge of sleep science and to improve current product performance and benefits. Through customer surveys and consumer focus groups, we seek feedback on a regular basis to help enhance our products.

Since the introduction of our first bed, we have continued to improve and expand our product line, including quieter Firmness Control Systems, remote control gauges with digital settings, more luxurious fabrics and covers, new generations of foams and foundation systems and enhanced border walls. Our research and development expenses were \$.9 million for 2000, \$1.9 million for 1999 and \$1.6 million for 1998.

RETAIL STORES

Since our first retail stores were opened in 1992, an increasing percentage of our net sales has occurred at our retail stores, and retail store sales now account for a majority of our net sales. At December 30, 2000, we had 333 stores in 45 states, including 25 leased departments. In 2001, we currently plan to close at least 14 under-performing retail locations and to open approximately 13 retail stores.

STORE ENVIRONMENT. Our previous store design featured novel visual images on the walls in order to command attention to our innovative products. In 2000 we adopted a new store design with a bedroom-like setting intended to convey a sense of sophistication and quality that reinforces Select Comfort's brand image as synonymous with sleep solutions. We remodeled approximately 66 of our stores with this updated retail store design in 2000. In connection with the launch of our Sleep Number campaign in two markets in January and six of our largest markets in February, the store marquees in these markets were changed to "The Sleep Number Store." Internal signage in all of our stores nationwide has been changed to support the Sleep Number brand and product message. Our retail stores are principally showrooms, averaging approximately 900 square feet, with several display models from our line of air beds and a full display of our branded accessories.

Our sales professionals play an important role in creating an inviting and informative retail environment. These professionals receive extensive training regarding the features and benefits of our proprietary technology and products as well as on the overall importance of sleep quality. This enables them to more effectively introduce consumers to our products, emphasize the features and benefits that distinguish Select Comfort beds from traditional mattresses, determine the consumers' needs, encourage consumers to experience the comfort and support of Sleep Number beds and answer questions regarding our products.

SITE SELECTION. In selecting new store sites, we generally seek high-traffic mall locations of approximately 800 to 1,200 square feet within malls in major metropolitan and regional areas. We conduct extensive analyses of potential store sites and base our selection on a number of factors, including the location within the mall, demographics of the trade area, the specifications of the mall (including size, age, sales per square foot and the location of the nearest competitive mall), the perceived strength of the mall's anchor stores, the performance of other specialty retail tenants in the mall, the number of direct marketing inquiries received from the area surrounding the mall, store density of existing stores and marketing and advertising plans in the respective markets. Clustering of retail stores within a metropolitan retail market is a key consideration in order to leverage our advertising.

MARKETING AND ADVERTISING. We historically have supported some of our multiple store markets with media primarily focused on the use of radio personalities. In connection with the Sleep Number campaign in selected markets, we have broadened our media reach and target audience through drive-time radio prime-time TV and periodic newspaper inserts. The Sleep Number campaign has to-date been introduced in two pilot markets and in six of our strongest markets, in terms of sales and store density, to best leverage the media spending. In addition, our integrated approach to marketing across our multiple channels is designed to deliver consistent messages about our Sleep Number beds and to direct customers to our retail stores.

We also support new store openings with mailings to direct response inquiries and potential prospects in the market, and in some markets with print and radio advertisements.

MANAGEMENT AND EMPLOYEES. Our stores are currently organized into six regional areas and 39 geographic districts, with approximately eight to 10 stores in each district. Each regional sales director oversees approximately seven geographic districts. Each district has a district sales manager who is responsible for the sales and operations and who reports to a regional sales director. The district sales managers frequently visit stores to review merchandise presentation, sales force product knowledge, financial performance and compliance with operating standards. The typical staff of a Select Comfort store consists of one store manager and two full-time sales professionals. In order to maintain high operating standards, we recruit store managers who typically have one to four years of experience as a store manager in specialty retailing. Our sales professionals devote substantially all of their efforts to sales and customer service, which includes helping customers and generating and responding to inquiries. In addition, to promote consumer education, ensure customer satisfaction and generate referrals, the sales professionals place follow-up calls to customers who have made recent purchases or inquiries.

TRAINING AND COMPENSATION. All store personnel receive comprehensive on-site training on our technology and sleep expertise, the features and benefits of our beds, sales and customer service techniques and operating policies and guidelines. Initial training programs are reinforced through detailed product and operating manuals and periodic performance appraisals. All store sales professionals receive base compensation and are entitled to commissions based on individual and store-wide performance. In 2001, our compensation program will be more heavily commission-based, which we believe will enable us to attract and retain more sales-oriented store professionals. Regional sales directors, district sales managers and store managers are eligible to receive, in addition to their base compensation, incentive compensation for the achievement of performance objectives by the stores within their responsibility.

DIRECT MARKETING OPERATIONS

Many consumers' initial exposure to the Select Comfort Sleep Number bed is through our direct marketing operations. Typically, an interested consumer will respond to one of our advertisements by calling our toll-free number.

On this call, one of our direct marketing sales professionals captures information from the consumer, begins the consumer education process, takes orders, or, if appropriate, sends a thorough information packet or directs the consumer to our other distribution channels (retail or e-commerce). The direct marketing operations are conducted by knowledgeable and well-trained sales professionals, including a group of over 30 sales professionals who field incoming direct marketing inquiries, and over 10 sales professionals who make outbound calls to consumers who have previously contacted us. The direct marketing operations also include a database marketing department that is responsible for the mailing of product and promotional information to direct response inquiries. We maintain a database of information on approximately 6.6 million inquiries, including customers who have purchased a bed from us.

In the direct marketing channel, our advertising message is communicated through targeted print and radio advertisements, use of infomercials and short-form direct TV advertising and through product brochures, videos and other product and promotional materials mailed in response to consumer inquiries at various intervals. Recently, the direct marketing channel has relied heavily on nationally syndicated radio personalities, such as Paul Harvey and Rush Limbaugh, and has expanded print and direct mail programs. Our direct marketing operations continually monitor the effectiveness and efficiency of our advertising through tracking the cost per inquiry and cost per order of our advertising, and use sophisticated media buying techniques to improve efficiency.

Our direct marketing operations also support our other distribution channels through referrals, as well as mailings to direct marketing inquiries in selected markets in advance of retail store openings and events. As our base of retail stores has expanded, our direct marketing sales professionals have increasingly been able to refer direct marketing inquiries to a convenient retail store location, improving the process of converting inquiries into sales and providing the consumer with a choice of service venues.

E-COMMERCE

Our Web site at selectcomfort.com provides consumers with a wide array of useful information as well as the convenience to order our products online or to call to order from one of our internet-dedicated sales professionals. Since building the capability to take online orders in May 1999, our e-commerce channel has continued to add functionality and content to educate consumers regarding:

- - sleep research and science,
- - our products and the benefits they provide,
- - store locations and other means to contact us and experience our products,
- - customer testimonials,
- - customer service information, and
- - current sales and promotional events.

Our e-commerce channel has also focused on developing relationships with online shopping malls and other sales portals and affiliates.

We launched our redesigned Web site in the second half of 2000 with an updated look and feel that is attractive, professional and reinforces the Select Comfort brand image. The redesigned site allows greater functionality to provide more personalization, guided selling, dynamic content and promotions and a more robust online shopping experience. The site is maintained through a content management system that allows for efficient management of Web site content as well as technical maintenance.

Earlier this year we launched a new site, sleepnumber.com, to support the Sleep Number brand in the advertising test markets. The site offers visitors the opportunity to estimate their Sleep Number online and includes a store locator to encourage them to visit a store to find their Sleep Number on a Sleep Number bed.

On March 28, 2001, we launched another site, beds.com, to increase awareness of the Sleep Number bed and air-supported sleep systems as

an important bed category. The target audience is shoppers at any point in the mattress consideration process. Beds.com provides mattress comparisons between types of beds (from innerspring to water), leading brands, important mattress features to look for, price and value and includes tips for choosing the right mattress. The site also provides specific information on the Sleep Number bed and links to selectcomfort.com for additional information. The beds.com site will be advertised on our online shopping portals and we intend to monitor traffic to the site and the impact on awareness levels and sales. Our goal is to increase awareness of our product category and its unique benefits, bringing the Sleep Number bed into the consideration set for people currently in the mattress shopping cycle.

MARKETING AND ADVERTISING

Lack of awareness among the broad consumer audience of our brand, product benefits and store locations has historically been our most significant barrier to growth. Despite significant cumulative advertising spending over the last few years, and our large customer base with extraordinary customer satisfaction ratings and referrals, we generally have relatively low levels of consumer awareness. Although awareness levels are higher in certain markets, our national brand awareness has only been about 3%, compared with 40% to 60% or more for some of our competitors offering traditional innerspring mattresses. Our current marketing efforts are therefore directed at increasing consumer awareness through a broader message, focused on the unique features and benefits of our product, delivered through broader reach media and appealing to a broader demographic audience.

In the second half of 2000, our marketing team focused on the repositioning of our product, brand and marketing messages around the unique and proprietary features and benefits of our Sleep Number bed. The Sleep Number bed offers adjustable and individualized firmness and a numerical representation of the consumer's ideal level of firmness, comfort and support to provide a perfect night's sleep. The architecture of the Sleep Number marketing campaign is that knowing your Sleep Number is the key to a perfect night's sleep; you can only find your Sleep Number on a Sleep Number bed; and you can only purchase a Sleep Number bed at The Sleep Number Store by Select Comfort. This architecture is designed to build strong brand, product and store awareness.

We believe this Sleep Number message enables consumers to more quickly understand the unique benefits of our product and has broader appeal than many of our traditional marketing messages.

In early 2001, a new integrated advertising campaign was introduced into eight test markets, and has produced favorable initial, in comparison with non-advertised markets.

Through the broader reach of prime-time TV and drive-time radio, the Sleep Number messages are targeted at a broader demographic audience than we have traditionally reached. The campaign includes five 30-second TV spots run at prime time on local network affiliates, seven 30-second radio spots, with periodic newspaper advertising for urgency messages. We are testing various levels of spending and media mixes with this advertising during 2001.

We have plans to roll this campaign to more markets in 2001, depending on the efficiency and effectiveness we see from the initial markets.

Though the initial focus of the Sleep Number campaign is on our retail stores, through the integration of our marketing messages across all of our channels, the Sleep Number repositioning is company-wide, including our direct and e-commerce channels. Retail store marquees have been changed to "The Sleep Number Store" only in the eight markets with full media support. Internal signage in all of our stores has been changed to support the Sleep Number brand and message.

The Sleep Number campaign is being funded by reductions in other less efficient advertising and

by reductions in promotional discounts that do not contribute to brand, product or store awareness levels. In total, year 2001 marketing expenditures are planned to be lower than the year 2000, despite this new initiative.

Though it is too soon to draw definitive conclusions regarding the effectiveness and efficiency of the Sleep Number campaign from the initial markets, early results indicate significant additional product and brand awareness, as well significant additional store traffic and sales in comparison with non-advertised markets.

CONSUMER EDUCATION AND CUSTOMER SERVICE

We are committed to achieving our goal of world class customer satisfaction and service. We intend to achieve this goal through a variety of means designed to:

- - educate consumers on the benefits of Select Comfort products,
- - deliver superior quality products,
- - maximize our direct relationship with consumers,
- - maximize convenience for the consumer, and
- - respond quickly to consumer needs and inquiries.

We believe that educating consumers about the features and benefits of our products is critical to the success of our marketing and sales efforts, and we devote considerable time and resources to training programs for our sales professionals. Our retail stores and our web site also provide customers with the latest information on sleep research and science and the benefits of our products.

Our controlled distribution channels optimize our direct contact with customers and allow us to respond quickly to customer service inquiries and enhance customer satisfaction. Our multiple distribution channels also enhance the convenience for the consumer to purchase products through a variety of venues. In addition, we have been testing the offering of in-home delivery, assembly and mattress removal services in selected markets. We are developing plans to ultimately provide these services nationwide across all of our distribution channels in order to increase overall sales and enhance customer satisfaction.

We maintain an in-house customer service department of over 40 customer service representatives who receive extensive training in sleep technology and all aspects of our products and operations. Our customer service representatives field customer calls and also interact with each of our retail stores to address customer questions and concerns raised with retail sales professionals. The customer service department makes outbound calls to new customers during our in home trial phase to answer questions and provide solutions to possible problems in order to enhance customer education, build customer satisfaction and reduce returns.

MANUFACTURING AND DISTRIBUTION

Our manufacturing operations are located in Minneapolis, Minnesota, Columbia, South Carolina, and Salt Lake City, Utah. These operations consist of quilting and sewing of the fabric covers for our beds, assembly of Firmness Control Systems and final assembly and packaging of mattresses and foundations from contract manufactured components. In April 2001, we discontinued manufacturing in our Minneapolis location. We will continue to process returns and warranty claims in this location, but manufacturing of our beds will occur only in our Columbia and Salt Lake City plants. We believe we have sufficient capacity in these plants to meet anticipated increases in demand for the foreseeable future.

We manufacture beds to meet orders rather than to stock inventory, which enables us to maintain lower levels of inventory. As we expand our home delivery and assembly services, we may use regional distribution centers that would stock inventory to fill orders on a more expedited basis. Orders are currently shipped

from one of our three distribution centers, primarily via UPS, typically within 48 hours following order receipt, and are usually received by the customer within five to seven business days after shipment. We are continually evaluating alternative carriers on a national and regional basis, as well as testing providers of in-home assembly services in selected markets.

SUPPLIERS

We currently obtain all of the materials and components used to produce our beds from outside sources. Components for the Firmness Control Systems are obtained from a variety of domestic sources. Quilting and ticking materials are obtained from a supplier that produces both in Belgium and in the United States. Components for foundation systems are obtained primarily from two domestic sources.

Our proprietary air chambers are produced to our specifications by one Eastern European supplier under a supply contract expiring in August 2001 (subject to automatic renewal if neither party gives 90 days' notice of non-renewal), pursuant to which we are obligated to purchase certain minimum quantities. We expect to continue the relationship with the Eastern European supplier for the foreseeable future. We believe that we would be able to procure an adequate supply of air chambers from other sources on a timely basis if the supply contract is terminated or the Eastern European supplier is otherwise unable to supply air chambers.

INTELLECTUAL PROPERTY

Certain elements of the design and function of our beds and sofa sleeper products are the subject of United States and foreign patents and patent applications owned by us. We have 37 issued U.S. patents and 27 U.S. patent applications pending. We also held 15 foreign patents and had 22 foreign patent applications pending as of December 30, 2000.

The name "Select Comfort" and our logo are trademarks registered with the United States Patent and Trademark Office. We have a number of other registered marks, including the trademarks "Sleep Number" and "Sleep Insurance," the service marks "Comfort Club" and "Sleep Better on Air," and a number of unregistered marks, including the trademark "The Sleep Number Bed by Select Comfort" and the service mark "The Sleep Number Store by Select Comfort." Several of these trademarks have been registered, or are the subject of pending applications, in various foreign countries. Each federally registered mark is renewable indefinitely if the mark is still in use at the time of renewal. We are not aware of any material claims of infringement or other challenges to our right to use our marks.

In November 1999, we initiated a patent infringement suit against Simmons Company and Price Manufacturing Inc. alleging that Simmons-branded air beds manufactured by Price Manufacturing infringed three of our patents. In February 2000, we settled our suit against Simmons after Simmons terminated its license agreement with Price Manufacturing, effectively ending Simmons' involvement with the manufacture and sale of air beds with a hand control that are the subject of the suit. Price Manufacturing was not a part of the settlement and we intend to continue to prosecute our suit against Price Manufacturing.

COMPETITION

The mattress industry is highly competitive. Participants in the mattress industry compete primarily on price, quality, brand name recognition, product availability and product performance, including the perceived levels of comfort and support provided by a mattress. Our beds compete with a number of different types of mattress alternatives, including innerspring mattresses, waterbeds, futons and other air-supported mattresses that are sold through a variety of channels, including furniture stores, bedding specialty stores, department stores, mass merchants, wholesale clubs, telemarketing programs, television infomercials and catalogs. We believe that our success depends in part on increasing consumer awareness and acceptance of our existing products and the continuing

introduction of products that have qualities and benefits which differentiate our products from those offered by other manufacturers.

The traditional mattress industry is characterized by a high degree of concentration among the four largest manufacturers of innerspring mattresses with nationally recognized brand names, including Sealy, which also owns the Stearns & Foster brand name, Serta, Simmons and Spring Air. The balance of the mattress market is served by over 700 manufacturers, primarily operating on a regional basis. Many of these competitors, and in particular the four largest manufacturers named above, have greater financial, marketing and manufacturing resources and better brand name recognition than we do, and sell their products through broader and more established distribution channels.

A number of companies have begun to offer air beds in recent years, including Simmons. There can be no assurance that these companies or any other mattress manufacturer, including the major innerspring manufacturers named above, will not aggressively pursue the air bed market or be successful in obtaining significant market share of the air bed category. Any such competition by established manufacturers or new entrants into the market could have a material adverse effect on our business, financial condition and operating results. In addition, should any of our competitors reduce prices on premium mattress products, we may be required to implement price reductions in order to remain competitive, which could have a material adverse effect on our business, financial condition and operating results.

CONSUMER CREDIT ARRANGEMENTS

Through a private label consumer credit facility provided by Conseco Bank, Inc. (the "Bank"), we offer our qualified customers an unsecured revolving credit arrangement to finance purchases from us. The Bank sets the rates, fees and all other terms and conditions of the customer accounts, including collection policies and procedures, and is the owner of the accounts. In connection with all purchases financed under these arrangements, the Bank pays us an amount equal to the total amount of such purchases, net of promotional related discounts.

We have recently been in discussions with the Bank regarding the terms under which the Bank will continue to make this credit facility available to our customers. As a result of these discussions, we have agreed to establish a reserve in the amount of \$1 million to protect the Bank against potential losses from consumer returns. This reserve will be established in part from the proceeds of our pending financing transaction and in part through a discount from the proceeds of credit sales that we receive from the Bank. We have also agreed that, in the event of any termination of our agreement with the Bank and replacement of the Bank by an alternative third-party provider of consumer financing, at the request of the Bank we will purchase the Bank's outstanding portfolio of customer accounts for a pre-determined formula price.

GOVERNMENTAL REGULATION

Our products and our marketing and advertising practices are subject to regulation by various federal, state and local regulatory authorities, including the Federal Trade Commission. The mattress industry also engages in advertising self-regulation through certain voluntary forums, including the National Advertising Division of the Better Business Bureau. We are also subject to various other federal, state and local regulatory requirements, including federal, state and local environmental regulation and regulations issued by the U.S. Occupational Safety and Health Administration.

EMPLOYEES

At December 30, 2000, we employed 1,853 persons, including 1,185 retail store employees, 53 direct marketing employees 72 customer service employees, 327 manufacturing and distribution employees and 216 management and administrative employees. Approximately 191 of our employees were employed on a part-

time basis at December 30, 2000. Except for managerial employees and professional support staff, all of our employees are paid on an hourly basis plus commissions for sales associates. None of our employees is represented by a labor union or covered by a collective bargaining agreement. We believe that our relations with our employees are good.

CERTAIN RISK FACTORS

There are several important risk factors that could cause our actual results to differ materially from those anticipated by us or which may impact any of our forward-looking statements. These factors, and their impact on the success of our operations and our ability to achieve our goals, include the following:

HISTORY OF OPERATING LOSSES; UNCERTAIN PROFITABILITY. Since inception, we have incurred substantial operating losses and there can be no assurance that our business and growth strategy will enable us to achieve profitability on a quarterly or annual basis in future periods. Our future operating results will depend on a number of factors, including:

- - Our ability to successfully execute the strategic initiatives outlined above under "--Business and Growth Strategy,"
- - The efficiency and effectiveness of our Sleep Number campaign and other marketing programs in building product and brand awareness, driving traffic to our points of sale and in increasing sales,
- - The level of consumer acceptance of our products,
- - Our ability to fully execute and realize the benefits of the cost savings initiatives outlined above under "--Business and Growth Strategy,"
- - Our ability to cost-effectively sell our products through wholesale or alternative distribution channels in volumes sufficient to drive growth and leverage our cost structure and advertising spending,
- - Our ability to continuously improve our products to achieve new and enhanced consumer benefits, better quality and reduced costs,
- - Our ability to realize increased sales and greater levels of profitability through our retail stores,
- - Our ability to cost-effectively close additional underperforming or unprofitable store locations, or to negotiate rent concessions,
- - Our ability to hire, train, manage and retain qualified retail store management and sales professionals,
- - Our ability to maintain cost-effective production and delivery of our products,
- - Our ability to successfully expand our home delivery, assembly and mattress removal capability on a cost-effective basis,
- - The ability of various third-party providers of delivery, assembly and mattress removal services to provide quality services on a cost-effective basis,
- - Our ability to successfully commercialize our sofa sleeper product line across our distribution channels and in major markets,
- - Our ability to successfully identify and respond to emerging trends in the mattress industry,
- - The level of competition in the mattress industry,
- - General economic conditions and consumer confidence.

There can be no assurance that we will be successful in achieving our strategic plan or that

this strategic plan will restore our company to historical sales growth rates or to profitability. Failure to successfully execute any material part of our strategic plan could have a material adverse effect on our business, financial condition and operating results.

LIQUIDITY AND CAPITAL RESOURCES. The report of our independent accountants contains an explanatory paragraph expressing substantial doubt about the Company's ability to continue as a going concern as a result of our negative cash flows and pre-tax operating losses of \$26.0 million and \$15.0 million in 2000 and 1999, respectively, and negative working capital of \$18.2 million at December 30, 2000. As a result of fiscal 2000 operating losses and the recent downturn in the economy, which has adversely affected our sales trends, our current cash flows may not be sufficient to meet our near-term liquidity needs. Our near-term cash needs are further impacted by (i) the seasonality of our business, with lower sales volumes historically occurring during the second quarter, (ii) the timing of marketing and advertising expenditures, which are higher in the early part of the year when direct marketing advertising rates are more favorable, and (iii) working capital needs as we expand our wholesale activities through a significant QVC sales event planned for May. Based on the estimated cash impact of the items outlined above, offset in part by more aggressive efforts to manage our working capital needs, we estimate that between \$2 million and \$8 million of additional working capital is required during the second and third quarters.

Since the beginning of fiscal 2000, we have undertaken efforts to substantially reduce our cost structure as outlined above in "-- Business and Growth Strategy." Following the recent downturn in the economy and evaluation of the related impact on our anticipated sales volumes, we implemented further cost saving initiatives. We expect that these cost reductions, along with efforts to increase our product and brand awareness, improve our sales conversion effectiveness and expand our points of distribution, will result in positive cash flows from operations for the second half of fiscal 2001.

Since the fourth quarter of 2000, we have been pursuing \$10 million or more of working capital financing from a variety of potential sources. Due to our traditional business model, under which we manufacture product to meet consumer orders and maintain minimal levels of finished goods inventory, the recent economic downturn, and recent tightening of credit markets, we have been unable to obtain traditional asset-based financing. We therefore have recently begun pursuing a private placement of \$10 million to \$12 million of senior secured debt securities convertible into shares of our common stock together with detachable warrants to purchase additional shares of our common stock. Consummation of this financing as currently contemplated would result in substantial dilution to current shareholders.

We have received non-binding indications of interest from several potential investors for a significant portion of the minimum amount of this private placement, and we are continuing to have discussions with other potential investors. We believe that we will be able to consummate this financing. However, binding commitments have not been received and significant conditions to closing remain to be met, and therefore no assurance can be given that we will be able to consummate this financing on satisfactory terms, or at all.

In addition to pursuing the financing described above, we have been aggressively managing our costs and cash flow to preserve and extend our cash resources. Near the end of 2000, we began to undertake efforts to rightsize our cost structure. The economic downturn at the end of 2000 adversely affected sales trends, resulting in the identification and execution of additional cost reduction measures. Efforts included termination of non-core business initiatives, closure of certain facilities, including one of three manufacturing facilities, one of two administrative offices and one of two call centers, closure of 27 stores in 2000 with plans to close 14 stores in 2001,

reduction of corporate and administrative overhead and staffing, and adjustment of advertising, promotional and other marketing programs. We are also pursuing programs to improve our liquidity, including negotiation of supplier and landlord payment terms, the reduction of inventory levels and the deferral of capital programs.

We believe that the financing mentioned above, or other alternatives that might become available, planned and implemented cost reduction efforts and the aggressive management of current and future cash resources will provide sufficient working capital to fund our operations for the foreseeable future. If for any reason we are unable to obtain additional financing, or if our cash management efforts were not sufficient to preserve enough cash to meet our near-term liquidity needs, we may not be able to continue as a going concern, which may result in material asset impairment or restructuring charges, other material adverse changes in our business, results of operations or financial condition, or the loss by shareholders of all or a part of their investment in the Company.

See "Management's Discussion and Analysis of Financial Condition and results of Operations - Liquidity and Capital Resources."

EFFECTIVENESS AND EFFICIENCY OF ADVERTISING EXPENDITURES. Advertising expenditures were \$33.4 million, \$43.4 million and \$31.6 million in 2000, 1999 and 1998, respectively. Our overall marketing spending is being managed downward, but with greater emphasis toward awareness-building advertising. Our future growth and profitability will be dependent in part on the effectiveness and efficiency of our advertising expenditures, including our ability to:

- - create greater awareness of our products and brand name,
- - determine the appropriate creative message and media mix for future advertising expenditures,
- - effectively manage advertising costs (including creative and media) in order to maintain acceptable costs per inquiry, costs per order and operating margins, and
- - convert inquiries into actual orders.

No assurance can be given that our planned advertising expenditures will result in increased sales, will generate sufficient levels of product and brand name awareness or that we will be able to manage our advertising expenditures on a cost-effective basis.

FLUCTUATIONS IN COMPARABLE STORE SALES RESULTS. Our comparable store sales results have fluctuated significantly in the past and these fluctuations are likely to continue. Stores enter the comparable store calculation in their 13th full month of operation. Our comparable store sales increases were 0.2% for 2000, 4.7% for 1999, 17.9% for 1998 and 34.6% for 1997.* Our comparable store sales results have fluctuated significantly from quarter to quarter with increases ranging from -4.1% to 36% on a quarterly basis for 1997 through 2000. There can be no assurance that our comparable store sales results will not fluctuate significantly in the future.

A variety of factors affect our comparable store sales results, including:

- - levels of consumer awareness of our products, brand name and store locations,
- - levels of consumer acceptance of our existing and new products,
- - higher levels of sales in the first year of operations as each successive class of new stores is opened,
- - comparable store sales performance in prior periods,
- - the maturation of our store base,

- - - - -
* Fiscal 1997 was a 53-week year versus 52 weeks for 1999 and 1998. Comparable store sales for 1998 and 1997, adjusted to 52 weeks, would be 27.3% and 26.1%, respectively.

- - the amount, timing and relative success of promotional events, advertising expenditures, new product introductions and product line extensions,
 - - the quality and tenure of store-level managers and sales professionals,
 - - the amount of competitive activity,
 - - the evolution of store operations,
 - - changes in the sales mix between our distribution channels, and
 - - general economic conditions and consumer confidence.
- Decreases in comparable store sales results could have a material adverse effect on our business, financial condition and operating results.

QUARTERLY FLUCTUATIONS AND SEASONALITY. Our quarterly operating results may fluctuate significantly as a result of a variety of factors, including:

- - increases or decreases in comparable store sales,
- - the timing, amount and effectiveness of advertising expenditures,
- - any increases in return rates,
- - the timing of new store openings and related expenses,
- - competitive factors,
- - net sales contributed by new stores,
- - any disruptions in third-party delivery services, and
- - general economic conditions and consumer confidence.

Our business is also subject to some seasonal influences, with lower seasonal sales in the second quarter and heavier concentrations of sales during the fourth quarter holiday season due to higher mall traffic.

The level of spending related to sales and marketing expenses and new store opening costs cannot be adjusted quickly and is based, in significant part, on our expectations of future customer inquiries and net sales. If there is a shortfall in expected net sales or in the conversion rate of customer inquiries, we may be unable to adjust our spending in a timely manner and our business, financial condition and operating results may be materially adversely affected. Our results of operations for any quarter are not necessarily indicative of the results that may be achieved for a full year or any future quarter.

RELIANCE UPON PROVIDER OF CONSUMER CREDIT FACILITY. Through a private label consumer credit facility provided by Conseco Bank, Inc. (the "Bank"), we offer our qualified customers an unsecured revolving credit arrangement to finance purchases from us. The Bank sets the rates, fees and all other terms and conditions of the customer accounts, including collection policies and procedures, and is the owner of the accounts. In connection with all purchases financed under these arrangements, the Bank pays us an amount equal to the total amount of such purchases, net of promotional related discounts.

We have recently been in discussions with the Bank regarding the terms under which the Bank will continue to make this credit facility available to our customers. As a result of these discussions, we have agreed to establish a reserve in the amount of \$1 million to protect the Bank against potential losses from consumer returns. This reserve will be established in part from the proceeds of our pending financing transaction and in part through a discount from the proceeds of credit sales that we receive from the Bank. We have also agreed that, in the event of any termination of our agreement with the Bank and replacement of the Bank by an alternative third-party provider of consumer financing, at the request of the Bank we will purchase the Bank's outstanding portfolio of customer accounts for a pre-determined formula price.

Our agreement with the Bank also contains a provision permitting the Bank to terminate the agreement in the event of a material adverse change in our operations, financial condition, business or prospects. If we are unable to obtain additional financing, no assurance can be given that the Bank will not take action to terminate the agreement or request material changes to the

terms under which the Bank will continue to provide financing for our customers. Termination of our agreement with the Bank, or any material change to the terms of our agreement with the Bank or in the availability or terms of credit for our customers from the Bank, could have a material adverse effect on our business, sales, results of operations or financial condition.

RELIANCE UPON SUPPLIERS; SINGLE SOURCE OF SUPPLY OF AIR CHAMBERS; FOREIGN SOURCES OF SUPPLY. The inability of our suppliers to meet, for any reason, our requirements for any components of our bed products, or our requirements of sofa sleeper products, could have a material adverse effect on our business, financial condition and operating results. Our air chambers are currently obtained from a single source of supply. If this supplier became unable or unwilling for any reason to continue to supply us with air chambers, our operations could be materially adversely affected. We currently have a supply agreement with this single source of supply that expires in August 2001 (subject to automatic renewal if neither party gives 90 days' notice of non-renewal), but there can be no assurance that this single source of supply will not be disrupted for any reason. In addition, since our air chambers and certain other supplies are manufactured outside the United States, our operations could be materially adversely affected by the risks associated with foreign sourcing of materials, including:

- - political instability resulting in disruption of trade,
- - existing or potential duties, tariffs or quotas that may limit the quantity of certain types of goods that may be imported into the United States or increase the cost of such goods, and
- - any significant fluctuation in the value of the dollar against foreign currencies.

With the exception of our air chambers, we have no long-term purchase contracts or other contractual assurances of continued supply, pricing or access to components. The inability or failure of one or more key suppliers to supply components, the loss of one or more key suppliers or a material change in our purchase terms could have a material adverse effect on our business, financial condition and operating results.

RELIANCE UPON CARRIERS. Historically, we have relied almost exclusively on UPS for delivery of our products to customers. For a significant portion of the third quarter of 1997, UPS was unable to deliver our products within acceptable time periods, causing delays in deliveries to customers and requiring us to use alternative carriers. No assurance can be given that UPS will not experience difficulties in meeting our requirements in the future. In 2000, we began to shift a portion of our product delivery business to Federal Express. We continue to evaluate alternative carriers on a national and regional basis, as well as providers of in-home delivery and assembly services. There can be no assurance that alternative carriers will be able to meet our requirements on a timely or cost-effective basis. Any significant delay in deliveries to customers or increase in freight charges may have a material adverse effect on our business, financial condition and operating results.

RETURN POLICY AND PRODUCT WARRANTY. Part of our marketing and advertising strategy focuses on providing an in-home trial period during which customers may return their Sleep Number bed and obtain a refund of the purchase price. We plan to shorten this in-home trial period from 90 nights to 30 nights effective as of May 29, 2001. We believe that a 30-night trial period is competitive within our industry and sufficient to enable consumers to experience the features and benefits of our products. No assurance can be given, however, that this change in policy will not have a material adverse effect on our sales volumes or return rates. Any significant decrease in sales volumes or increase in return rates could have a material adverse effect on our business, financial condition and operating results. We also provide our customers with a limited 20-year warranty on our beds. We have only been selling beds in significant quantities since 1992. There can be no assurance that our

warranty reserves will be adequate to cover future warranty claims. Significant warranty claims in excess of our warranty reserves could have a material adverse effect on our business, financial condition and operating results.

SALES TAX CONSIDERATIONS. Prior to May 2000, in compliance with state and federal tax regulations, our direct marketing and e-commerce channels did not collect sales tax from customers residing in certain states. Industry experts believe these regulations potentially provide a competitive advantage to direct marketers and e-commerce companies over retailers located within these states and who are required to collect sales tax. In connection with our provision of in-home delivery and assembly of our products to customers through all of our distribution channels, as well as the execution of our integrated marketing plan, we began collecting sales tax on sales in all states. While we believe the execution of these initiatives will positively impact the overall performance of our company, the impact of this change could negatively impact sales.

PRODUCT DEVELOPMENT AND ENHANCEMENTS. Our growth and future success will depend upon our ability to enhance our existing products and to develop and market new products on a timely basis that respond to customer needs and achieve market acceptance. There can be no assurance that we will be successful in developing or marketing enhanced or new products, or that any such products will be accepted by the market. Further, there can be no assurance that the resulting level of sales of any of our enhanced or new products will justify the costs associated with their development and marketing.

MARKET ACCEPTANCE. The U.S. mattress market is dominated by four large manufacturers of innerspring mattresses. Our air chamber technology represents a significant departure from traditional innerspring mattresses. The market for air beds is continuing to evolve and the success of our products will be dependent upon both the continued growth of this market and upon market acceptance of our beds. The failure of our beds to achieve market acceptance for any reason would have a material adverse effect on our business, financial condition and operating results.

INTELLECTUAL PROPERTY PROTECTION. No assurance can be given that our current patents or pending patent applications will provide substantial protection or that others will not be able to develop products that are similar to or competitive with our beds or other products. In addition, there can be no assurance that copyright, trademark, trade secret, unfair competition and other intellectual property laws, nondisclosure agreements and other protective measures will preclude competitors from developing products similar to our products or otherwise competing with us. In addition, the laws of certain foreign countries may not protect our intellectual property rights and confidential information to the same extent as the laws of the United States.

Although we are unaware of any basis for an intellectual property infringement or invalidity claim against us, there can be no assurance that third parties, including competitors, will not assert such claims against us or that, if asserted, such claims will not be upheld. Intellectual property litigation, which could result in substantial cost to and diversion of effort by management, may be necessary to enforce our patents, to protect our trade secrets and proprietary technology or to defend us against claimed infringement of the rights of others and to determine the scope and validity of the proprietary rights of others. There can be no assurance that we would prevail in any such litigation or that, if it is unsuccessful, we would be able to obtain any necessary licenses on reasonable terms or at all.

COMPETITION. The mattress industry is highly competitive. Our Sleep Number beds compete with a number of different types of mattress alternatives, including innerspring mattresses, waterbeds, futons and other air-supported mattresses that are sold through a variety of channels, including furniture stores, bedding

specialty stores, department stores, mass merchants, wholesale clubs, telemarketing programs, television infomercials and catalogs.

The traditional mattress industry is characterized by a high degree of concentration among the four largest manufacturers of innerspring mattresses with nationally recognized brand names, including Sealy, which also owns the Stearns & Foster brand name, Serta, Simmons and Spring Air. Over 700 manufacturers, primarily operating on a regional basis serve the balance of the mattress market. Many of these competitors, and in particular the four largest manufacturers named above, have greater financial, marketing and manufacturing resources and better brand name recognition than we do, and sell their products through broader and more established distribution channels.

A number of companies have begun to offer air beds in recent years, including Simmons. There can be no assurance that these companies or any other mattress manufacturer, including the major innerspring manufacturers named above, will not aggressively pursue the air bed market or be successful in obtaining significant market share of the air bed category. Any such competition by the established manufacturers or new entrants into the market could have a material adverse effect on our business, financial condition and operating results. In addition, should any of our competitors reduce prices on premium mattress products, we may be required to implement price reductions in order to remain competitive, which could have a material adverse effect on our business, financial condition and operating results.

SHAREHOLDER LITIGATION. Select Comfort and certain former officers and directors have been named as defendants in a class action lawsuit filed on behalf of shareholders in U.S. District Court in Minnesota. The named plaintiffs, who purport to act on behalf of a class of purchasers of our common stock during the period from December 4, 1998 to June 7, 1999, charge the defendants with violations of federal securities laws. The suit alleges that we and the former directors and officers failed to disclose or misrepresented certain information concerning our business during the class period. The complaint does not specify an amount of damages claimed. While we believe that the complaint is without merit and intend to vigorously defend the claims, there can be no assurance that we will be successful in defending the lawsuit. Defense of the suit could be expensive and may create a distraction to the management team. If we are unsuccessful in defending the suit, an adverse judgment could have a material adverse effect on our consolidated financial condition or results of operations.

POSSIBLE DELISTING FROM NASDAQ STOCK MARKET. Our common stock is currently quoted on the Nasdaq National Market under the symbol "SCSS." We are currently in compliance with Nasdaq's continued listing standards, including standards for minimum net tangible assets, public float, minimum bid price, number of shareholders and number of market makers. If we are unable to complete our private placement or obtain other financing, or if we are unable to successfully implement our strategic initiatives to achieve profitability, we may not be able to meet the financial requirements for continued listing on the Nasdaq National Market.

In the event that our common stock were to be delisted from the Nasdaq National Market and we were ineligible for listing on the Nasdaq SmallCap Market, our common stock would thereafter likely be quoted in the "over-the-counter" market and eligible to trade on the OTC bulletin board. If our common stock traded on the OTC bulletin board, trading, if any, would be subject to the "penny stock" rules under the Securities Exchange Act of 1934. Consequently, the liquidity of our common stock could be impaired, not only in the number of shares that could be bought and sold, but also through delays in the timing of the transactions, reductions in the security analysts' and the news media's coverage of our stock, and lower prices for our common stock than it might otherwise attain.

VOLATILITY IN MARKET PRICE OF COMMON STOCK. The market price of our common stock has fluctuated significantly in the past and may do so in the future. The market price of our common stock may fluctuate as a result of a variety of factors, many of which are outside of our control, including without limitation the following factors:

- - variations in quarterly operating results;
- - changes in estimates by securities analysts;
- - announcements of significant events;
- - additions or departures of key personnel; and
- - changes in market valuations of companies in our industry.

ITEM 2. PROPERTIES

We currently lease all of our existing retail store locations and expect that our policy of leasing, rather than owning, will continue as we expand. Our store leases generally provide for an initial lease term of 10 years with a mutual termination option if we do not achieve certain minimum annual sales thresholds. Generally, the store leases require us to pay minimum rent plus percentage rent based on net sales in excess of certain thresholds, as well as certain operating expenses.

We lease approximately 122,000 square feet of space in Minneapolis for one of our manufacturing and distribution centers, our direct marketing call center, a customer service center and a research and development center, which lease expires in 2004. We also lease approximately 105,000 square feet of space in Columbia, South Carolina, for another manufacturing and distribution center, which lease expires in 2003. We have also leased approximately 100,800 square feet in Salt Lake City for an additional manufacturing and distribution center, opened in May of 1999, which lease expires in 2009. We lease another 16,100 square feet of office space in the Minneapolis area, which we have vacated. We are in the process of seeking a sublessee for this space.

ITEM 3. LEGAL PROCEEDINGS

Select Comfort and certain former officers and directors were named as defendants in a class action lawsuit initially filed on June 1, 1999 on behalf of shareholders in U.S. District Court in Minnesota. The named plaintiffs, who purport to act on behalf of a class of purchasers of our common stock during the period from December 4, 1998 to June 7, 1999, charge the defendants with violations of federal securities laws. The suit alleges that we and the named directors and officers failed to disclose or misrepresented certain information concerning our business during the class period. The complaint does not specify an amount of damages claimed. We believe that the complaint is without merit and intend to vigorously defend the claims.

The Company and the individual defendants brought a motion to dismiss all claims on November 10, 1999. The motion was heard by a magistrate judge on December 21, 1999. On January 27, 2000, the magistrate recommended that the claims based on Section 11 of the federal securities laws be dismissed. The magistrate recommended that the motion to dismiss be denied with respect to the claims based on Rule 10b-5 of the federal securities laws. In February 2000, both the plaintiffs and the defendants formally objected to the magistrate's recommendation. The objection was made to the United States District Court in Minnesota. On May 12, 2000, the United States District Court in Minnesota adopted the recommendation of the magistrate and denied the defendants' motion to dismiss the Rule 10b-5 claims. The Court also adopted the recommendation of the magistrate and dismissed the plaintiff's Section 11 claims without prejudice and with leave to amend.

On March 31, 2000, the Company and certain of its former officers and directors were named as defendants in a class action lawsuit filed on

behalf of the Company's shareholders in U.S. District Court in Minnesota asserting identical factual allegations as the consolidated complaint described above. The suit alleges claims based on Sections 11 and 12(a)(2) of the federal securities laws. The complaint does not specify an amount of damages claimed. The Company believes this complaint is without merit and intends to vigorously defend the claims. The above two class actions were consolidated by the United States District Court Magistrate on July 24, 2000.

On January 30, 2001, the plaintiffs made a motion to certify a class. The class certification motion is pending. Discovery relative to this motion has begun.

We have agreed to indemnify the individual defendants and to advance reasonable expenses of defense of the litigation to the individual defendants under applicable Minnesota corporate law. To date, we have paid an aggregate of \$3,891 to the law firm of Briggs & Morgan on behalf of defendant H. Robert Hawthorne.

We are involved in other various claims, legal actions, sales tax disputes, and other complaints arising in the ordinary course of business. In the opinion of management, any losses that may occur are adequately covered by insurance or are provided for in the consolidated financial statements and the ultimate outcome of these matters will not have a material effect on the consolidated financial position or results of operations of the Company.

ITEM 4A. EXECUTIVE OFFICERS OF THE COMPANY

Our executive officers, their ages and the offices held, as of March 30, 2001, are as follows:

NAME	AGE	TITLE
William R. McLaughlin	44	President and Chief Executive Officer
Noel F. Schenker	47	Senior Vice President, Marketing and New Business Development
Gregory T. Kliner	63	Senior Vice President of Operations
James C. Raabe	41	Vice President and Chief Financial Officer
Mark A. Kimball	42	Senior Vice President, Chief Administrative Officer, General Counsel and Secretary
Michael J. Thyken	39	Vice President and Chief Information Officer
Tracey T. Breazeale	34	Senior Vice President, Special Projects

Information regarding the business experience of our executive officers is set forth below.

WILLIAM R. MCLAUGHLIN joined Select Comfort in March 2000 as President and Chief Executive Officer. From December 1988 to March 2000, Mr. McLaughlin served as an executive of Pepsico Foods International in various capacities, including from September 1996 to March 2000 as President of Frito Lay Europe, Middle East and Africa, and from June 1993 to June 1996 as President of Grupo Gamesa, a cookie and flour company based in Mexico.

NOEL F. SCHENKER joined Select Comfort as Senior Vice President, Marketing and New Business Development in November, 2000. Ms. Schenker served as Senior Vice President of Marketing and Strategic Planning at Rollerblade, Inc., from 1992 to 1996, and as an independent consultant from 1996 to 2000. She was with The Pillsbury Company from 1981 to 1992, serving as Vice President of Marketing for the Green Giant business. Since 1996, she also has served on the Board of Directors and Executive Committee of the Fortis Financial Group's Mutual Funds.

GREGORY T. KLINER has served as Senior Vice President of Operations of Select Comfort since August 1995. From October 1986 to August 1995, Mr. Kliner served as Director of Operations of the Irrigation Division for The Toro Company, a manufacturer of lawn care and snow removal products and irrigation systems.

JAMES C. RAABE was elected as Vice President and Chief Financial Officer of Select Comfort in April 1999. From September 1997 to April 1999, Mr. Raabe served as Controller of Select Comfort. From May 1992 to September 1997, Mr. Raabe served as Vice President - Finance of ValueRx, Inc., a pharmacy benefit management provider. Mr. Raabe held various positions with KPMG LLP from August 1982 to May 1992.

MARK A. KIMBALL joined Select Comfort in May 1999 as Senior Vice President, Chief Administrative Officer, General Counsel and Secretary. For more than five years prior to joining Select Comfort, Mr. Kimball was a partner in the law firm of Oppenheimer Wolff &

Donnelly LLP practicing in the area of corporate finance.

MICHAEL J. THYKEN joined Select Comfort in July 2000 as Vice President and Chief Information Officer. During 1999, Mr. Thyken was Group Director of Application Development at Jostens, a Minneapolis based manufacturer of scholastic recognition products. From 1994 to 1999, Mr. Thyken was Director of Technical Services for Target Stores. From 1984 to 1994, Mr. Thyken served in various positions with IBM Corporation.

TRACEY T. BREAZEALE was hired as Senior Vice President of Strategic Planning and Branding of Select Comfort in July 1999. In February 2001, Ms. Breazeale's work schedule was reduced to 25% of full time, and her title was changed to Senior Vice President, Special Projects. Ms. Breazeale was with the Boston Consulting Group from October 1993 to July 1999, initially as a consultant and the last three years as a manager, where she specialized on strategic and marketing oriented projects for retail and consumer product companies.

PART II

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

Our common stock trades on the Nasdaq Stock Market under the symbol SCSS. The quarterly high and low sales prices for the common stock, as reported by the Nasdaq Stock Market, for the two most recent fiscal years follows in the table below. These quotations reflect inter-dealer prices, without retail mark-up, mark-down or commission, and may not necessarily represent actual transactions.

	Fourth Quarter	Third Quarter	Second Quarter	First Quarter
Fiscal 2000				
High	\$2.44	\$3.50	\$5.50	\$6.50
Low	\$0.96	\$1.44	\$2.38	\$4.38
Fiscal 1999				
High	\$7.06	\$9.19	\$29.88	\$35.25
Low	\$3.63	\$6.00	\$6.38	\$20.50

NUMBER OF RECORD HOLDERS; DIVIDENDS

As of March 28, 2001, there were 178 record holders of our common stock. We did not declare or pay any cash dividends on the common stock during the fiscal years ended December 30, 2000 or January 1, 2000 and do not anticipate paying any cash dividends on our common stock in the foreseeable future.

USE OF PROCEEDS FROM INITIAL PUBLIC OFFERING

On September 3, 1998, we filed a Registration Statement on Form S-1 (File No. 333-62793) with the Securities and Exchange Commission, pursuant to which we registered the offer and sale under the federal securities laws of 4,600,000 shares of common stock, including 1,677,650 shares sold by certain selling shareholders. The SEC declared our Registration Statement effective on December 3, 1998, and the closing of the initial public offering was held on December 9, 1998. The managing underwriters were Hambrecht & Quist LLC, BankBoston Robertson Stephens Inc., Piper Jaffray Inc. and Charles Schwab & Co., Inc.

The aggregate offering price of all shares sold in the offering was \$78,200,000. The net proceeds to Select Comfort from the sale of the shares of common stock offered by Select Comfort was \$44,643,353, after deducting the underwriting discount of \$3,477,597 and offering expenses of approximately \$1,559,000. All of the expenses incurred in connection with the initial public offering were paid to unrelated parties or entities, except for the underwriting discount which was given to, among others, Hambrecht & Quist LLC. Jean-Michel Valette, a director of the Company, was a member of the general partner of H&Q Select Comfort Investors, L.P., a related party to Hambrecht & Quist LLC.

From December 9, 1998 to December 30, 2000, the net proceeds from the offering have been used as follows:

Repayment of long-term debt.....	\$15,325,480
Repurchase of our common stock.....	12,692,054
Fund the build-out, start-up and leasing of our third manufacturing and distribution facility.....	1,712,306
Fund development of warranty and inquiry system.....	1,032,099
Fund partial expansion of our retail store base.....	13,881,414

	\$44,643,353
	=====

ITEM 6. SELECTED FINANCIAL DATA

The data presented below has been derived from the Company's consolidated financial statements and should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations" and the Company's consolidated financial statements and notes thereto included in this Annual Report on Form 10-K:

	YEAR ENDED (1)				
	DEC. 30, 2000	JAN. 1, 2000	JAN. 2, 1999	JAN. 3, 1998	DEC. 28, 1996
CONSOLIDATED STATEMENTS OF OPERATIONS DATA:					
Net sales	\$270,077	\$273,767	\$246,269	\$184,430	\$102,028
Gross margin	171,153	178,660	161,082	117,801	63,507
Operating income (loss)(2)	(25,970)	(14,793)	11,445	1,996	(3,764)
Net income (loss) before extraordinary item	(37,214)	(8,204)	6,636	(2,846)	(3,685)
Net income (loss)	(37,214)	(8,204)	5,195	(2,846)	(3,685)
Net income (loss) per share - diluted (3):					
Net income (loss) per share before extraordinary item	(2.09)	(0.45)	0.28	(1.59)	(2.61)
Net income (loss) per share	(2.09)	(0.45)	0.19	(1.59)	(2.61)
Weighted average common shares - diluted	17,848	18,300	15,928	2,353	1,753
Dividends paid per share	-	-	-	-	-
SELECTED OPERATING DATA:					
Stores open at period-end (4)	333	341	264	200	143
Average square footage of stores open during period (5)	913	893	895	866	768
Sales per square foot (5)	697	721	742	666	622
Average store age (in months at period end)	41	31	27	22	15
Comparable store sales increase (6)	0.2%	4.7%	23.5%	27.3%	26.1%
CONSOLIDATED BALANCE SHEET DATA:					
Cash and cash equivalents	\$1,498	\$7,441	\$45,561	\$12,670	\$2,422
Marketable securities	3,950	20,129	-	-	-
Working capital	(18,176)	14,470	42,249	757	(7,809)
Total assets	64,672	95,865	106,234	57,241	29,794
Long-term debt, less current maturities	2,322	36	29	19,511	1,162
Mandatorily redeemable preferred stock	-	-	-	27,612	27,612
Total common shareholders' equity (deficit)	16,600	52,872	70,691	(21,038)	(18,216)

- (1) Except for the year ended January 3, 1998, which included 53 weeks, all years presented included 52 weeks.
- (2) Includes charges for impairment of assets of \$1.9 million for the year ended December 30, 2000 and \$1.5 million for the year ended January 1, 2000. See Note 5 to the Consolidated Financial Statements.
- (3) See Note 11 of Notes to Consolidated Financial Statements.
- (4) Includes Select Comfort stores operated in leased departments within larger retail stores (25 at December 30, 2000, 45 at January 1, 2000, 14 at January 2, 1999 and one at January 3, 1998).
- (5) For stores open during the entire period indicated.
- (6) Stores enter the comparable store calculation in their 13th full month of operation. The number of comparable stores used to calculate such data were 314, 262, 199, 138 and 65 for fiscal 2000, 1999, 1998, 1997 and 1996, respectively. Reflects adjustment for additional week of sales in 1997. Without adjusting for the additional week, comparable store sales would have been 17.9% in 1998 and 34.6% in 1997.

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

FORWARD LOOKING STATEMENTS

The following discussion and analysis should be read in conjunction with the Consolidated Financial Statements and the Notes thereto included herein. This discussion contains forward looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Statements that are not of historical fact may be deemed to be forward-looking statements. Without limiting the foregoing, words such as "may," "will," "expect," "believe," "anticipate," "estimate" or "continue" or comparable terminology are intended to identify forward-looking statements. These statements by their nature involve substantial risks and uncertainties, and actual results may differ materially depending on a variety of factors, including those set forth above in Part I, Item 1 under the heading entitled "Certain Risk Factors."

OVERVIEW

Select Comfort is the leading manufacturer, specialty retailer and direct marketer of premium quality innovative air beds and sleep-related products. Since the introduction of our first air bed product in 1987, we have focused on improving our product, expanding our product line, building manufacturing and distribution systems and growing our three distribution channels: retail, direct marketing and e-commerce. Vertically integrated operations and control over these complementary distribution channels gives us direct contact with our customers and gives our customers multiple opportunities to purchase our products. Sales generation is driven primarily by targeted print, radio, television, and internet media that generate customer inquiries, as well as by our retail store and internet presence.

Since the latter half of 2000, we have focused on five primary strategic priorities: (i) building consumer awareness, (ii) rightsizing our cost structure, (iii) improving our sales conversion effectiveness, (iv) pursuing alternative distribution channels, and (v) continuously improving product quality, innovation and service levels. Each of these strategic priorities is discussed in greater detail above under "Business - Business and Growth Strategy." The success of our strategy will depend on many factors and is subject to certain risks, including the risks and uncertainties outlined above under "Business - Certain Risk Factors."

Retail operations included 333 stores at December 30, 2000, including 25 leased departments within larger stores, 341 stores at January 1, 2000, (including 45 leased departments) and 264 stores at January 2, 1999 (including 14 leased departments). During 2000, we opened 19 stores and closed 27 stores. In 2001, we currently plan to open approximately 13 additional retail stores, primarily in existing markets, and plan to close approximately 14 underperforming stores. The majority of the costs associated with these closings were accrued in 2000.

The Company reported comparable store sales growth of 0.2%, 4.7% and 23.5% in 2000, 1999 and 1998, respectively. Comparable store sales results have been and will continue to be influenced by a variety of factors, including:

- - levels of consumer awareness of our products, brand name and store locations,
- - levels of consumer acceptance of our existing and new products,
- - higher levels of sales in the first year of operations as each successive class of new stores is opened,
- - comparable store sales performance in prior periods,
- - the maturation of our store base,
- - the amount, timing and relative success of promotional events, advertising expenditures, new product introductions and product line extensions,
- - the quality and tenure of store-level managers and sales professionals,
- - the amount of competitive activity,
- - the evolution of store operations,

- - changes in the sales mix between our distribution channels, and
- - general economic conditions and consumer confidence.

Advertising expenditures were \$33.4 million, \$43.4 million and \$31.6 million in 2000, 1999 and 1998, respectively. Advertising costs are expensed as incurred as a component of sales and marketing expenses, although we believe that advertising expenditures provide significant benefits beyond the period in which they are expensed. Future advertising expenditures will depend on the effectiveness and efficiency of the advertising in creating awareness of our products and brand name, generating consumer inquiries and driving consumer traffic to retail stores. Pre-opening costs associated with new retail stores are also expensed as incurred.

We believe historical operating losses have been primarily the result of an aggressive retail store opening strategy, a relatively immature store base, significant marketing, advertising and product development expenditures, and the development of a substantial corporate infrastructure to support future growth. Future increases in net sales and the achievement of long-term profitability will depend upon greater consumer awareness and acceptance of our air bed products, improved effectiveness and efficiency of our marketing and advertising expenditures, the opening and successful performance of new points of distribution, improvement in the performance of current stores and our ability to realize the benefits of our cost saving initiatives. There can be no assurance that we will be able to achieve or sustain historical sales growth rates, or to achieve profitability in the future, on a quarterly or annual basis.

Quarterly and annual operating results may fluctuate significantly as a result of a variety of factors, including increases or decreases in comparable store sales, the timing, amount and effectiveness of advertising expenditures, any changes in return rates, the timing of new store openings and related expenses, competitive factors, net sales contributed by new stores, any disruptions in third-party delivery services and general economic conditions and consumer confidence. Our business is also subject to some seasonal influences, with heavier concentrations of sales during the fourth quarter holiday season due to increased mall traffic.

A substantial portion of operating expenses is related to sales and marketing expenses, including costs associated with opening new stores, operating existing stores and advertising expenditures. The level of such spending cannot be adjusted quickly and is based, in significant part, on expectations of future customer inquiries and net sales. Furthermore, a substantial portion of net sales is often realized in the last month of a quarter with such net sales frequently concentrated in the last weeks or days of a quarter, due in part to our promotional schedule. Should the Company experience a shortfall in expected net sales or in the conversion rate of customer inquiries, we may be unable to adjust spending in a timely manner and our business, financial condition and operating results may be materially adversely affected. Our historical results of operations may not be indicative of the results that may be achieved for any future fiscal period.

At December 30, 2000, we had net operating loss carryforwards ("NOLs") for federal income tax purposes of approximately \$31.4 million expiring between the years 2003 and 2020. We expect that approximately \$1.4 million of these NOLs will expire unutilized due to an Internal Revenue Code (IRC) Section 382 limitation resulting from a prior ownership change. Realization of the benefit of the deferred tax assets depends on us achieving profitability levels sufficient to utilize the NOLs.

RESULTS OF OPERATIONS

The following table sets forth, for the periods indicated, the Company's results of operations expressed as percentages of net sales. Percentage amounts may not total due to rounding.

	Percentage of Net Sales		
	Year Ended		
	Dec. 30, 2000	Jan. 1, 2000	Jan. 2, 1999
Net sales	100.0%	100.0%	100.0%
Cost of sales	36.6	34.7	34.6
Gross margin	63.4	65.3	65.4
Operating expense:			
Sales and marketing	61.4	59.4	52.7
General and administrative	10.8	10.7	8.0
Store closing/impairments	0.7	0.5	0.0
Total operating expenses	73.0	70.7	60.8
Operating income (loss)	(9.6)	(5.4)	4.7
Other income (expense), net	0.1	0.6	(2.9)
Income (loss) before income taxes	(9.5)	(4.8)	1.8
Income tax expense(benefit)	4.3	(1.8)	(0.9)
Net income (loss) before ext, net	(13.8)	(3.0)	2.7
Extraordinary item	(0.0)	0.0	(0.6)
Net income (loss)	(13.8)%	(3.0)%	2.1%

The operating loss in 2000 was largely due to a decline in net sales, and an increase in operating expenses as a percentage of net sales, reflecting the growth of our retail store selling infrastructure. The decline in net sales was due to a number of factors. Advertising spending was reduced by \$10.0 million (23%) in 2000 compared to 1999, as the efficiency of advertising programs declined and the Company worked to develop new creative advertising programs. Additionally, seasonal traffic in our retail stores fell short of expectations, due in part to a softening economic climate during the fourth quarter of 2000. Finally, direct marketing sales declined by \$24.3 million in 2000 compared to 1999, primarily due to the continued migration of the Company's sales from direct marketing to retail stores and due to the reduction of advertising spending in this channel. Selling expenses increased by \$12.9 million resulting in the net overall increase in operating expenses. The increase resulted primarily from higher occupancy and compensation expenses resulting from an increase in the number of stores open for a full year in 2000. Special charges of \$3.5 million are included in the 2000 results related to store closings, asset impairments and severance costs related to two reductions in workforce.

As noted above under "Overview" and "Business - Business and Growth Strategy," we have implemented several strategic initiatives that we believe will result in improved operating results in 2001.

COMPARISON OF FISCAL 2000 AND FISCAL 1999

NET SALES

Net sales in 2000 decreased 1.3% to \$270.1 million from \$273.8 million in 1999. The components of the decrease in net sales were (i) a \$22.0 million increase from the opening of 19 new retail stores during 2000 and the full year impact of 77 stores opened in 1999, (ii) a \$0.4 million increase from a 0.2% increase in comparable store sales, (iii) a \$5.2 million increase in net sales from the Company's e-commerce channel, offset by (iv) a \$24.3 million decrease in direct marketing sales and (v) a \$7.0 million decrease due to the elimination of our road show distribution channel.

GROSS MARGIN

Gross margin in 2000 decreased to 63.4% from 65.3% in 1999 primarily due to larger discounts on promotional offerings, increased costs from processing returned product and increased costs from the rollout of our new foundation product, partially offset by a price increase for some of our products.

SALES AND MARKETING

Sales and marketing expenses in 2000 increased 2.0% to \$166.0 million from \$162.7 million in 1999, and increased as a percentage of net sales to 61.4% in 2000 from 59.4% in 1999. The increase in the dollar amount of sales and marketing expenses during 2000 was primarily due to (i) higher occupancy expense related primarily to rent and depreciation expense, (ii) higher wages and compensation expense and (iii) higher freight costs. Sales and marketing

expenses increased as a percentage of net sales primarily due to (i) lower direct marketing sales and (ii) selling expenses in new stores increasing at a greater rate than net sales and the expenses

associated with the rollout of our sofa sleeper product, partially offset by (iii) a decrease in media spending.

GENERAL AND ADMINISTRATIVE

General and administrative expenses in 2000 were \$29.2 million, equal to the 1999 expense level. Slight increases in wages and benefits expense were offset by reductions in the use of outside services and consultants.

STORE CLOSINGS/IMPAIRMENTS

Store closing/impairment expense in 2000 was \$2.0 million, up from \$1.5 million in 1999. In 2000, this expense included \$1.4 million related to the relocation of our headquarter offices and web development costs and \$0.6 million related to store closures. The expense of \$1.5 million in 1999 relates almost exclusively to store closures.

OTHER INCOME (EXPENSE), NET

Other income decreased \$1.4 million to approximately \$0.3 million of other income in 2000 from \$1.7 million in other income in 1999. The decrease is due to lower cash levels affecting interest income in 2000. In addition, the recognition of an equity loss in SleepTec following our acquisition of this business reduced other income by \$0.6 million.

INCOME TAX EXPENSE (BENEFIT)

Income tax expense increased to \$11.6 million for 2000 from a benefit of \$4.8 million for 1999. Income tax expense increased as a result of the establishment of an additional \$21.1 million deferred tax asset valuation allowance in the fourth quarter of 2000 resulting from uncertainties in the Company's business. See "Liquidity and Capital Resources."

COMPARISON OF FISCAL 1999 AND FISCAL 1998

NET SALES

Net sales in 1999 increased 11.2% to \$273.8 million from \$246.3 million in 1998, primarily due to an increase in unit sales. The components of the increase in net sales were (i) a \$33.6 million increase from the opening of 77 new retail stores during 1999 and the full year impact of 64 stores opened in 1998, (ii) a \$6.8 million increase from a 4.7% increase in comparable store sales, due in part to the continuing maturation of stores and increased advertising in selected markets, (iii) a \$4.3 million increase in net sales from the Company's newly developed e-commerce channel, partially offset by (iv) a \$15.3 million decrease in direct marketing sales.

GROSS MARGIN

Gross margin in 1999 decreased to 65.3% from 65.4% in 1998. Reductions in cost of sales from improved purchasing and leverage of fixed manufacturing costs over higher unit volumes were offset by higher sales discounts.

SALES AND MARKETING

Sales and marketing expenses in 1999 increased 25.3% to \$162.7 million from \$129.9 million in 1998, and increased as a percentage of net sales to 59.4% in 1999 from 52.7% in 1998. The increase in the dollar amount of sales and marketing expenses during 1999 was primarily due to (i) the opening of 77 new retail stores, (ii) an increase in advertising expenditures of \$11.8 million and (iii) higher commissions, percentage rents and freight expense related to higher net sales. Sales and marketing expenses increased as a percentage of net sales primarily due to (i) increased advertising focused on longer term sales growth through brand and retail store awareness, (ii) lower direct marketing sales and (iii) selling expenses in new stores increasing at a greater rate than net sales.

GENERAL AND ADMINISTRATIVE

General and administrative expenses in 1999 increased 48.1% to \$29.2 million from \$19.7 million in 1998. The increase in general and administrative expenses was primarily due to increased spending on infrastructure to support long-term growth plans and strategic consulting studies undertaken to determine and refine ongoing business strategies.

STORE CLOSINGS

Store closing expense in 1999 was \$1.5 million, compared with \$20,000 in 1998. Store closing expense for 1999 includes a \$1.4 million charge associated with plans to close 10 stores and other related store write-offs.

OTHER INCOME (EXPENSE), NET

Other income increased \$8.8 million to approximately \$1.8 million of other income in 1999 from \$7.0 million in other expense in 1998. The increase was primarily due to (i) the inclusion of \$5.6 million of non-cash interest expense in 1998 relating to the change in the fair value of an outstanding put warrant and (ii) an increase in interest income on the cash obtained from the completion of our initial public offering in December 1998. The put provision associated with the warrant was eliminated effective on completion of the initial public offering.

INCOME TAX EXPENSE (BENEFIT)

Income tax benefit increased to \$4.8 million in 1999 from \$2.2 million in 1998 due to a decrease in taxable income in 1999.

EXTRAORDINARY ITEM

Net income in 1998 includes an extraordinary charge, net of income tax benefits, of \$1.4 million. The charge relates to the write-off of certain deferred assets associated with our \$15.0 million debt financing, which was repaid in December 1998.

LIQUIDITY AND CAPITAL RESOURCES

The report of our independent accountants contains an explanatory paragraph expressing substantial doubt about the Company's ability to continue as a going concern as a result of our negative cash flows. The Company has incurred pre-tax losses from operations of \$26.0 million and \$15.0 million in 2000 and 1999, respectively, and had negative working capital of \$18.2 million at December 30, 2000. As a result of fiscal 2000 operating losses and the recent downturn in the economy, which has adversely affected our sales trends, our current cash flows may not be sufficient to meet our near-term liquidity needs. Our near-term cash needs are further impacted by (i) the seasonality of our business, with lower sales volumes historically occurring during the second quarter, (ii) the timing of marketing and advertising expenditures, which are higher in the early part of the year when direct marketing advertising rates are more favorable, and (iii) working capital needs as we expand our wholesale activities through a significant QVC sales event planned for May. Based on the estimated cash impact of the items outlined above, offset in part by more aggressive efforts to manage our working capital needs, we estimate that between \$2 million and \$8 million of additional working capital is required during the second and third quarters.

Since the beginning of fiscal 2000, we have undertaken efforts to substantially reduce our cost structure as outlined above in "Business -- Business and Growth Strategy." Following the recent downturn in the economy and evaluation of the related impact on our anticipated sales volumes, we implemented further cost saving initiatives. We expect that these cost reductions, along with efforts to increase our product and brand awareness, improve our sales conversion effectiveness and expand our points of distribution, will result in positive cash flows from operations for the balance of fiscal 2001.

Since the fourth quarter of 2000, we have been pursuing \$10 million or more of working capital financing from a variety of potential sources. Due to our traditional business model, under which we manufacture product to meet consumer orders and maintain minimal levels of finished goods inventory, the recent economic downturn, and recent tightening of credit markets, we have been unable to obtain traditional asset-based financing.

We therefore have recently begun pursuing a private placement of Senior Secured Convertible Debentures in a minimum aggregate principal amount of \$10 million and a maximum aggregate principal amount of \$12 million. The principal amount of the Debentures would (i) be secured by a lien on the Company's assets (subordinated only to up to \$5 million of senior bank financing), (ii) mature five years after the closing, (iii) bear interest at 8% payable annually in cash and (iii) be convertible into common stock initially at the rate of \$1.00 per share, subject to anti-dilution provisions. In addition, for each \$1,000,000 in principal amount of Debentures purchased, investors would receive detachable warrants to purchase up to 300,000 shares of common stock of the

Company at an initial exercise price of \$1.33 per share, subject to anti-dilution provisions. Debentures in the minimum aggregate principal amount of \$10 million and the related warrants would represent the right to acquire more than 20% of our outstanding common stock and would therefore require approval of our shareholders under Nasdaq rules in order to maintain our listing on the Nasdaq Stock Market. The issuance of the Debentures would further be subject to customary representations, warranties and covenants, including specified events of default that may result in the acceleration of the maturity of the Debentures, as well as certain conditions to closing, including (i) the sale of Debentures in the minimum principal amount of \$10 million, (ii) the receipt of binding proxies from holders of more than 50% of our outstanding shares of common stock to vote in favor of the transaction, (iii) the receipt by our Board of Directors of a fairness opinion from an independent financial advisor and (iv) satisfactory due diligence and the execution and delivery of definitive documentation.

We have received non-binding indications of interest from several potential investors for a significant portion of the minimum amount of this private placement, and we are continuing to have discussions with other potential investors. We believe that we will be able to consummate this financing. However, binding commitments have not been received and significant conditions to closing remain to be met, and therefore no assurance can be given that we will be able to consummate this financing on the terms described above or on any other terms.

In addition to pursuing the financing described above, we have been aggressively managing our costs and cash flow to preserve and extend our cash resources. Near the end of 2000, we began to undertake efforts to rightsize our cost structure. The economic downturn at the end of 2000 adversely affected sales trends, resulting in the identification and execution of additional cost reduction measures. Efforts included termination of non-core business initiatives, closure of certain facilities, including one of three manufacturing facilities, one of two administrative offices and one of two call centers, closure of 27 stores in 2000 with plans to close 14 stores in 2001, reduction of corporate and administrative overhead and staffing, and adjustment of advertising, promotional and other marketing programs. We are also pursuing programs to improve our liquidity, including negotiation of supplier and landlord payment terms, the reduction of inventory levels and the deferral of capital programs.

We believe that the financing mentioned above, or other alternatives that might become available, planned and implemented cost reduction efforts and the aggressive management of current and future cash resources will provide sufficient working capital to fund operations for the foreseeable future. If for any reason we are unable to obtain additional financing, or if our cash management efforts were not sufficient to preserve enough cash to meet our near-term liquidity needs, we may not be able to continue as a going concern, which may result in material asset impairment or restructuring charges, other material adverse changes in our business, results of operations or financial condition, or the loss by shareholders of all or a part of their investment in the Company.

Historically, our primary source of liquidity has been the sale of equity securities. We completed our initial public offering in December 1998, resulting in net proceeds of \$44.6 million, which have been used for (i) the repayment of \$15.0 million of debt, (ii) expansion of retail stores, (iii) expansion of manufacturing capabilities, (iv) the repurchase of 1,220,000 shares of Company common stock for \$12.7 million and (v) the development of information technology systems. The Company had negative working capital of approximately \$18.2 million at December 30, 2000, and positive working capital of \$14.5 million at January 1, 2000.

Net cash used in 2000 operating activities was approximately \$10.3 million and consisted primarily of the net loss adjusted for non-cash expenses and an increase in accounts receivable, partially offset by a decrease in income taxes

receivable and an increase in accounts payable. Net cash provided by 1999 operating activities was approximately \$7.7 million and consisted primarily of net loss adjusted for non-cash expenses, decreases in accounts receivable and increases in accounts payable and accrued liabilities, partially offset by increases in inventories and income taxes receivable. Net cash provided by operating activities for 1998 was approximately \$11.0 million and consisted primarily of cash flows from operations before non-cash expenses, partially offset by increases in accounts receivable and decreases in accounts payable.

Net cash provided by investing activities in 2000 was approximately \$3.7 million. Net cash used in investing activities was approximately \$35.8 million and \$8.9 million in the years 1999 and 1998, respectively. Investing activities consisted of purchases of property and equipment for new retail stores in all periods, and for 1999 also included the opening of our Utah production facility. In 2000 we liquidated \$16.2 million of marketable securities to support our continuing operations, while in 1999 we purchased \$20.1 million of marketable securities for the investment of excess cash on hand.

Net cash provided by (used in) financing activities for 2000, 1999 and 1998 was approximately \$0.7 million, (\$10.0) million, \$30.7 million, respectively. Net cash provided by financing activities in 2000 resulted from cash received from the issuance of common stock. Net cash used in financing activities for 1999 was due to repurchases of common stock and debt repayments, partially offset by cash received from issuance of common stock. During 1999, the Company repurchased 1,220,000 shares of common stock for approximately \$12.7 million. Net cash provided by financing activities for 1998 consisted primarily of proceeds from completion of our initial public offering, partially offset by debt repayments. Financial instruments that potentially subject us to concentrations of credit risk consist principally of investments. The counterparties to the agreements consist of government agencies and various major corporations of high credit standing. We do not believe there is significant risk of non-performance by these counterparties because we limit the amount of credit exposure to any one financial institution and any one type of investment.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

Information concerning disclosure about market risk is set forth in Note 3 to our Consolidated Financial Statements included in this report.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The consolidated financial statements are listed under item 14 of this report.

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

None.

PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

DIRECTORS, EXECUTIVE OFFICERS, PROMOTERS AND CONTROL PERSONS

The information under the captions "Election of Directors - Information About Nominees and Directors" and "Election of Directors - Other Information About Nominees and Directors" in our 2001 Proxy Statement is incorporated herein by reference. The information concerning executive officers of Select Comfort is included in this Report under Item 4a, "Executive Officers of the Company."

SECTION 16(A) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE

The information under the caption "Section 16(a) Beneficial Ownership Reporting Compliance" in our 2001 Proxy Statement is incorporated herein by reference.

ITEM 11. EXECUTIVE COMPENSATION

The information under the captions "Election of Directors - Director Compensation" and "Executive Compensation and Other Benefits" in our 2001 Proxy Statement is incorporated herein by reference.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The information under the caption "Principal Shareholders and Beneficial Ownership of Management" in our 2001 Proxy Statement is incorporated herein by reference.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

The information under the caption "Certain Transactions" in our 2001 Proxy Statement is incorporated herein by reference.

PART IV

ITEM 14. EXHIBITS, FINANCIAL STATEMENT SCHEDULES AND REPORTS ON FORM 8-K

(a) 1. INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

Page Number in
this Report

Independent Auditors' Report.....	F-1
Consolidated Balance Sheets as of December 30, 2000 and January 1, 2000.....	F-2
Consolidated Statements of Operations for the years ended December 30, 2000, January 1, 2000 and January 2, 1999.....	F-3
Consolidated Statements of Shareholders' Equity for the years ended December 30, 2000, January 1, 2000 and January 2, 1999.....	F-4
Consolidated Statements of Cash Flows for the years ended December 30, 2000, January 1, 2000 and January 2, 1999.....	F-5
Notes to Consolidated Financial Statements.....	F-6 to F-18
Management's Report.....	F-19

2. INDEX TO CONSOLIDATED FINANCIAL STATEMENT SCHEDULES

The following Report and financial statement schedule are included in this Part IV and are found in this Report at the pages indicated.

Independent Auditors' Report on Schedule.....	S-1
Schedule II - Valuation and Qualified Accounts.....	S-1

All other schedules are omitted because they are not applicable or the required information is included in the consolidated financial statements or notes thereto.

3. EXHIBITS

The exhibits to this Report are listed in the Exhibit Index below.

Select Comfort will furnish a copy of any of the exhibits referred to above at a reasonable cost to any shareholder upon receipt of a written request therefor. Requests should be sent to: Select Comfort Corporation, 6105 Trenton Lane North, Minneapolis, Minnesota 55442; Attn: Shareholder Information.

The following is a list of each management contract or compensatory plan or arrangement required to be filed as an exhibit to this Annual Report on Form 10-K pursuant to Item 14(c):

1. Form of Incentive Stock Option Agreement under the 1997 Stock Incentive Plan
2. Form of Performance Based Stock Option Agreement under the 1997 Stock Incentive Plan
3. Employment Letter dated July 11, 1995 between the Company and Gregory T. Kliner
4. Employment Letter dated November 12, 1997 between the Company and Ronald E. Mayle
5. Select Comfort Profit Sharing and 401(K) Plan
6. Select Comfort Corporation 1999 Employee Stock Purchase Plan
7. Select Comfort Corporation 1990 Omnibus Stock Option Plan, as amended and restated
8. Select Comfort Corporation 1997 Stock Incentive Plan, as amended and restated
9. Employment Letter dated July 21, 1999 between the Company and Tracey T. Breazeale
10. Employment Letter dated April 22, 1999 between the Company and Mark A. Kimball
11. Executive and Key Employee Incentive Plan
12. Employment Letter dated March 3, 2000 between the Company and William R. McLaughlin
13. Employment Letter dated July 11, 2000 between the Company and Michael J. Thyken
14. Employment Letter dated October 27, 2000 between the Company and Noel F. Schenker

(b) REPORTS ON FORM 8-K

During the quarter ended December 30, 2000, we filed one Current Report on Form 8-K. This report was filed on November 22, 2000 to report the acquisition by the Company of certain assets and business of SleepTec, Inc. This Current Report on Form 8-K was amended on February 16, 2001 to include the following financial statements:

Audited Financial Statements of SleepTec, Inc. as of December 31, 1999 and for the year ended December 31, 1999 and the period August 13, 1997 (date of incorporation) to December 31, 1999.

Unaudited Interim Financial Statements of SleepTec, Inc. as of September 30, 2000 and for the nine months ended September 30, 2000 and 1999.

Unaudited Pro Forma Condensed Combined Financial Information as of September 30, 2000 and for the year ended January 1, 2000 and for the nine months ended September 30, 2000.

SIGNATURES

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

SELECT COMFORT CORPORATION

Dated: April 16, 2001 By: /s/ William R. McLaughlin

William R. McLaughlin
President and Chief Executive Officer
(principal executive officer)

By: /s/ James C. Raabe

James C. Raabe
Chief Financial Officer
(principal financial and accounting officer)

Pursuant to the requirements of the Securities Exchange Act of 1934, this Report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

NAME	TITLE	DATE
----- /s/ Patrick A. Hopf ----- Patrick A. Hopf	Chairman of the Board	April 16, 2001
----- /s/ William R. McLaughlin ----- William R. McLaughlin	President and Chief Executive Officer, Director	April 16, 2001
----- /s/ Ervin R. Shames ----- Ervin R. Shames	Director	April 16, 2001
----- /s/ Thomas J. Albani ----- Thomas J. Albani	Director	April 15, 2001
----- /s/ Christopher P. Kirchen ----- Christopher P. Kirchen	Director	April 16, 2001

/s/ David T. Kollat

David T. Kollat

Director

April 13, 2001

Jean-Michel Valette

Director

April , 2001

SELECT COMFORT CORPORATION
EXHIBIT INDEX TO ANNUAL REPORT ON FORM 10-K
FOR THE YEAR ENDED DECEMBER 30, 2000

EXHIBIT NO.	DESCRIPTION	METHOD OF FILING
3.1	Restated Articles of Incorporation of the Company, as amended.....	Incorporated by reference to Exhibit 3.1 contained in Select Comfort's Annual Report on Form 10-K for the fiscal year ended January 1, 2000 (File No. 0-25121)
3.2	Restated Bylaws of the Company.....	Incorporated by reference to Exhibit 3.2 contained in the Select Comfort's Registration Statement on Form S-1, as amended (File No. 333-62793)
4.1	Form of Warrant issued in connection with the sale of Convertible Preferred Stock, Series E.....	Incorporated by reference to Exhibit 4.2 contained in Select Comfort's Registration Statement on Form S-1, as amended (File No. 333-62793)
4.2	Form of Warrant issued in connection with the November 1996 Bridge Financing.....	Incorporated by reference to Exhibit 4.3 contained in the Select Comfort's Registration Statement on Form S-1, as amended (File No. 333-62793)
4.3	Amended and Restated Registration Rights Agreement dated December 28, 1995.....	Incorporated by reference to Exhibit 4.4 contained in the Select Comfort's Registration Statement on Form S-1, as amended (File No. 333-62793)
4.4	First Amendment to Series E Stock Purchase Agreement and Amended and Restated Registration Rights Agreement dated April 25, 1996.....	Incorporated by reference to Exhibit 4.5 contained in Select Comfort's Registration Statement on Form S-1, as amended (File No. 333-62793)
4.5	Second Amendment to Amended and Restated Registration Rights Agreement dated as of November 1, 1996.....	Incorporated by reference to Exhibit 4.6 contained in Select Comfort's Registration Statement on Form S-1, as amended (File No. 333-62793)
4.6	Second (sic) Amendment to Amended and Restated Registration Rights Agreement dated March 24, 1997..	Incorporated by reference to Exhibit 4.7 contained in Select Comfort's Registration Statement on Form S-1, as amended (File No. 333-62793)

4.7	Series A Warrant effective as of March 31, 1998 issued to General Electric Capital Corporation.....	Incorporated by reference to Exhibit 4.8 contained in Select Comfort's Registration Statement on Form S-1, as amended (File No. 333-62793)
4.8	Convertible Subordinated Debenture dated as of November 10, 2000, between Select Comfort and SleepTec, Inc.....	Incorporated by reference to Exhibit 4.1 contained in Select Comfort's Current Report on Form 8-K filed November 22, 2000 (File No. 0-25121)
10.1	Net Lease Agreement dated December 3, 1993 between the Company and Opus Corporation.....	Incorporated by reference to Exhibit 10.1 contained in Select Comfort's Registration Statement on Form S-1, as amended (File No. 333-62793)
10.2	Amendment of Lease dated August 10, 1994 between the Company and Opus Corporation.....	Incorporated by reference to Exhibit 10.2 contained in the Select Comfort's Registration Statement on Form S-1, as amended (File No. 333-62793)
10.3	Second Amendment to Lease dated May 10, 1995 between the Company and Rushmore Plaza Partners Limited Partnership (successor to Opus Corporation).....	Incorporated by reference to Exhibit 10.3 contained in Select Comfort's Registration Statement on Form S-1, as amended (File No. 333-62793)
10.4	Letter Agreement dated as of October 5, 1995 between the Company and Rushmore Plaza Partners Limited Partnership.....	Incorporated by reference to Exhibit 10.4 contained in Select Comfort's Registration Statement on Form S-1, as amended (File No. 333-62793)
10.5	Third Amendment of Lease, Assignment and Assumption of Lease and Consent dated as of January 1, 1996 among the Company, Rushmore Plaza Partners Limited Partnership and Select Comfort Direct Corporation...	Incorporated by reference to Exhibit 10.5 contained in Select Comfort's Registration Statement on Form S-1, as amended (File No. 333-62793)
10.6	Sublease dated as of March 27, 1997 between Select Comfort SC Corporation and Bellsouth Telecommunications, Inc.....	Incorporated by reference to Exhibit 10.6 contained in Select Comfort's Registration Statement on Form S-1, as amended (File No. 333-62793)
10.7	Supply Agreement dated August 23, 1994 between the Company and Supplier (1).....	Incorporated by reference to Exhibit 10.8 contained in Select Comfort's Registration Statement on Form S-1, as amended (File No. 333-62793)

10.8	Major Merchant Agreement dated December 19, 1997 among First National Bank of Omaha and the Company, Select Comfort SC Corporation, Select Comfort Retail Corporation and Select Comfort Direct Corporation...	Incorporated by reference to Exhibit 10.13 contained in Select Comfort's Registration Statement on Form S-1, as amended (File No. 333-62793)
10.9	Form of Incentive Stock Option Agreement under the 1997 Stock Incentive Plan.....	Incorporated by reference to Exhibit 10.16 contained in the Company's Registration Statement on Form S-1, as amended (File No. 333-62793)
10.10	Form of Performance Based Stock Option Agreement under the 1997 Stock Incentive Plan.....	Incorporated by reference to Exhibit 10.17 contained in Select Comfort's Registration Statement on Form S-1, as amended (File No. 333-62793)
10.11	Employment Letter Agreement dated July 11, 1995 between the Company and Gregory T. Kliner.....	Incorporated by reference to Exhibit 10.20 contained in Select Comfort's Registration Statement on Form S-1, as amended (File No. 333-62793)
10.12	Employment Letter Agreement dated November 12, 1997 between the Company and Ronald E. Mayle.....	Incorporated by reference to Exhibit 10.20 contained in Select Comfort's Annual Report on Form 10-K for the fiscal year ended January 2, 1999 (File No. 0-25121)
10.13	Lease Agreement dated September 30, 1998 between the Company and ProLogis Development Services Incorporated.....	Incorporated by reference to Exhibit 10.28 contained in Select Comfort's Registration Statement on Form S-1, as amended (File No. 333-62793)
10.14	Revolving Credit Program Agreement by and between Green Tree Financial Corporation and Select Comfort Corporation (1).....	Incorporated by reference to Exhibit 10.3 contained in Select Comfort's Quarterly Report on Form 10-Q for the quarter ended July 3, 1999 (File No. 0-25121)
10.15	Letter of Agreement by and between Bed, Bath & Beyond Inc. and Select Comfort Retail Corporation (1).....	Incorporated by reference to Exhibit 10.4 contained in Select Comfort's Quarterly Report on Form 10-Q for the quarter ended July 3, 1999 (File No. 0-25121)
10.16	Select Comfort Profit Sharing and 401(K) Plan.....	Incorporated by reference to Exhibit 10.5 contained in Select Comfort's Quarterly Report on Form 10-Q for the quarter ended July 3, 1999 (File No. 0-25121)

10.17	Select Comfort Corporation 1999 Employee Stock Purchase Plan, as amended.....	Filed herewith electronically
10.18	Select Comfort Corporation 1990 Omnibus Stock Option Plan, as amended and restated.....	Incorporated by reference to Exhibit 10.1 contained in Select Comfort's Quarterly Report on Form 10-Q for the quarter ended October 2, 1999 (File No. 0-25121)
10.19	Select Comfort Corporation 1997 Stock Incentive Plan, as amended and restated.....	Incorporated by reference to Exhibit 10.1 contained in Select Comfort's Quarterly Report on Form 10-Q for the quarter ended July 1, 2000 (File No. 0-25121)
10.20	Employment Letter Agreement dated July 21, 1999 between the Company and Tracey T. Breazeale.....	Incorporated by reference to Exhibit 10.24 contained in Select Comfort's Annual Report on Form 10-K for the fiscal year ended January 1, 2000 (File No. 0-25121)
10.21	Employment Letter Agreement dated April 22, 1999 between the Company and Mark A. Kimball.....	Incorporated by reference to Exhibit 10.25 contained in Select Comfort's Annual Report on Form 10-K for the fiscal year ended January 1, 2000 (File No. 0-25121)
10.22	Executive and Key Employee Incentive Plan.....	Filed electronically herewith
10.23	Employment Letter dated March 3, 2000 between the Company and William R. McLaughlin.....	Incorporated by reference to Exhibit 10.1 contained in Select Comfort's Quarterly Report on Form 10-Q for the quarter ended April 1, 2000
10.24	Employment Letter dated July 11, 2000 between the Company and Michael J. Thyken.....	Filed electronically herewith
10.25	Employment Letter dated October 27, 2000 between the Company and Noel F. Schenker.....	Filed electronically herewith
10.26	Asset Purchase Agreement dated as of November 10, 2000, among SleepTec, Inc., St. Paul Venture Capital IV, LLC, St. Paul Venture Capital V, LLC, St. Paul Venture Capital VI, LLC and Select Comfort Corporation.....	Incorporated by reference to Exhibit 2.1 contained in Select Comfort's Current Report on Form 8-K filed November 22, 2000 (File No. 0-25121)

- 10.27 Letter Agreement dated as of July 1, 2000 between
Messner Vetere Berger McNamee Schmetterer/Euro RSCG
Inc. and Select Comfort Retail Corporation..... Filed electronically herewith
- 21.1 Subsidiaries of the Company..... Incorporated by reference to
Exhibit 21.1 contained in
Select Comfort's Annual Report
on Form 10-K for the fiscal
year ended January 1, 2000
(File No. 0-25121)
- 23.1 Independent Auditors' Consent..... Filed electronically herewith
- 27.1 Financial Data Schedule..... Filed electronically herewith

(1) Confidential treatment has been granted by the Securities and Exchange Commission with respect to designated portions contained within document. Such portions have been omitted and filed separately with the Securities and Exchange Commission pursuant to Rule 24b-2 of the Securities and Exchange Act of 1934, as amended.

INDEPENDENT AUDITORS' REPORT

The Board of Directors and Shareholders
Select Comfort Corporation:

We have audited the accompanying consolidated balance sheets of Select Comfort Corporation and subsidiaries (the Company) as of December 30, 2000 and January 1, 2000 and the related consolidated statements of operations, shareholders' equity, and cash flows for each of the fiscal years in the three-year period ended December 30, 2000. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits 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. 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 consolidated financial statements referred to above present fairly, in all material respects, the financial position of Select Comfort Corporation and subsidiaries as of December 30, 2000 and January 1, 2000, and the results of their operations and their cash flows for each of the fiscal years in the three-year period ended December 30, 2000 in conformity with accounting principles generally accepted in the United States of America.

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 1 to the financial statements, the Company has incurred negative cash flows that raise substantial doubt about its ability to continue as a going concern. Management's plans in regard to these matters are also described in Note 1. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

Minneapolis, Minnesota
February 2, 2001, except with respect to Notes 1 and 10
which are as of April 12, 2001

/s/ KPMG LLP

SELECT COMFORT CORPORATION
AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS
DECEMBER 30, 2000 AND JANUARY 1, 2000
(IN THOUSANDS, EXCEPT SHARE AND PER SHARE AMOUNTS)

ASSETS	2000	1999
	-----	-----
Current assets:		
Cash and cash equivalents	\$ 1,498	\$ 7,441
Marketable securities (note 3)	3,950	20,129
Accounts receivable, net of allowance for doubtful accounts of \$264, and \$305, respectively	2,693	1,056
Inventories (note 4)	11,083	11,451
Prepaid expenses	4,741	4,821
Income taxes (note 10)	-	2,579
Deferred tax assets (note 10)	-	6,639
	-----	-----
Total current assets	23,965	54,116
	-----	-----
Property and equipment, net (note 5)	37,063	34,823
Deferred tax assets (note 10)	-	4,248
Other assets	3,644	2,176
	-----	-----
Total assets	\$64,672	\$95,363
	=====	=====
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Current maturities of long-term debt (note 7)	\$ 38	\$ 51
Accounts payable	17,271	15,911
Accruals:		
Sales returns	5,284	5,880
Warranty costs	7,181	5,841
Compensation, taxes and benefits	6,238	6,678
Other	6,129	5,285
	-----	-----
Total current liabilities	42,141	39,646
Long-term debt, less current maturities (note 7)	2,322	36
Other liabilities	3,609	2,809
	-----	-----
Total liabilities	48,072	42,491
	-----	-----
Shareholders' equity (notes 1, 2, 7, 8, 9, 12, and 13):		
Undesignated preferred stock; 5,000,000 shares authorized, no shares issued and outstanding	-	-
Common stock, \$.01 par value; 95,000,000 shares authorized, 17,962,689 and 17,713,247 shares issued and outstanding, respectively	180	177
Additional paid-in capital	79,452	78,513
Accumulated deficit	(63,032)	(25,818)
	-----	-----
Total shareholders' equity	16,600	52,872
	-----	-----
Commitments and contingencies (notes 1, 6, and 14):		
Total liabilities and shareholders' equity	\$64,672	\$ 95,363
	=====	=====

See accompanying notes to consolidated financial statements.

SELECT COMFORT CORPORATION
AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS
YEARS ENDED DECEMBER 30, 2000, JANUARY 1, 2000 AND JANUARY 2, 1999
(IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)

	2000	1999	1998
Net sales	\$270,077	\$273,767	\$246,269
Cost of sales	98,924	95,107	85,187
Gross margin	171,153	178,660	161,082
Operating expenses:			
Sales and marketing	165,960	162,742	129,894
General and administrative	29,211	29,213	19,723
Store closings/asset impairments (note 5)	1,952	1,498	20
Total operating expenses	197,123	193,453	149,637
Operating income (loss)	(25,970)	(14,793)	11,445
Other income (expense):			
Interest income	1,082	1,956	825
Interest expense (note 7)	(26)	(69)	(7,834)
Equity in loss of affiliate (note 2)	(642)	-	-
Other, net	(66)	(116)	(32)
Other income (expense), net	348	1,771	(7,041)
Income (loss) before income taxes and extraordinary item	(25,622)	(13,022)	4,404
Income tax expense (benefit) (note 10)	11,592	(4,818)	(2,232)
Net income (loss) before extraordinary item	(37,214)	(8,204)	6,636
Extraordinary item, net of tax benefit (note 7)	-	-	(1,441)
Net income (loss)	\$(37,214)	\$(8,204)	\$ 5,195
Deemed dividend from revision of preferred stock conversion rate (note 8)	-	-	\$(1,312)
Cumulative preferred dividends	-	-	(821)
Net income (loss) available to common shareholders	\$(37,214)	\$(8,204)	\$ 3,062
Net income (loss) per share - basic (note 11)			
Net income (loss) before extraordinary item	\$ (2.09)	\$ (0.45)	\$ 1.09
Net income (loss)	(2.09)	(0.45)	0.74
Net income (loss) per share - diluted (note 11)			
Net income (loss) before extraordinary item	\$ (2.09)	\$ (0.45)	\$ 0.28
Net income (loss)	(2.09)	(0.45)	0.19

See accompanying notes to consolidated financial statements.

SELECT COMFORT CORPORATION
AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY
YEARS ENDED DECEMBER 30, 2000, JANUARY 1, 2000 AND JANUARY 2, 1999
(IN THOUSANDS, EXCEPT SHARE AMOUNTS)

	Shares	Amount	Additional Paid-in Capital	Accumulated Deficit	Notes Receivable- Investors	Total
	-----	-----	-----	-----	-----	-----
Balance at January 3, 1998	2,477,660	\$ 25	\$ 1,662	\$(22,307)	\$(418)	\$(21,038)
Issuance of shares in initial public offering (note 9)	2,922,350	29	44,614	-	-	44,643
Conversion of mandatorily redeemable preferred stock (note 8)	12,332,364	123	27,489	-	-	27,612
Exercise of common stock options and warrants	703,313	7	4,639	-	-	4,646
Issuance of investor notes	-	-	-	-	(487)	(487)
Payment of investor notes	-	-	-	-	905	905
Elimination of put provision on warrant (note 7)	-	-	9,215	-	-	9,215
Net income	-	-	-	5,195	-	5,195
	-----	-----	-----	-----	-----	-----
Balance at January 2, 1999	18,435,687	184	87,619	(17,112)	-	70,691
	-----	-----	-----	-----	-----	-----
Exercise of common stock options and warrants	479,855	5	3,470	-	-	3,475
Repurchase of common stock	(1,220,000)	(12)	(12,680)	-	-	(12,692)
Employee stock purchases (note 12)	17,705	-	104	-	-	104
Net loss	-	-	-	(8,204)	-	(8,204)
	-----	-----	-----	-----	-----	-----
Balance at January 1, 2000 as previously reported	17,713,247	177	78,513	(25,316)	-	53,374
	-----	-----	-----	-----	-----	-----
Acquisition of SleepTec, Inc. (note 2)	-	-	-	(502)	-	(502)
	-----	-----	-----	-----	-----	-----
Balance at January 1, 2000	17,713,247	177	78,513	(25,818)	-	52,872
	-----	-----	-----	-----	-----	-----
Exercise of common stock options and warrants	44,515	1	414	-	-	415
Employee stock purchases (note 12)	204,927	2	525	-	-	527
Net loss	-	-	-	(37,214)	-	(37,214)
	-----	-----	-----	-----	-----	-----
Balance at December 30, 2000	17,962,689	\$180	\$79,452	\$(63,032)	\$ -	\$ 16,600
	=====	=====	=====	=====	=====	=====

See accompanying notes to consolidated financial statements.

SELECT COMFORT CORPORATION
AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS
YEARS ENDED DECEMBER 30, 2000, JANUARY 1, 2000 AND JANUARY 2, 1999
(IN THOUSANDS)

	2000	1999	1998
Cash flows from operating activities:			
Net income (loss)	\$(37,214)	\$(8,204)	\$ 5,195
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
Depreciation and amortization	8,409	6,695	5,351
Loss on disposal of assets and impaired assets	2,167	1,297	50
Extraordinary item	-	-	1,441
Deferred tax assets	10,887	(4,998)	(5,888)
Interest expense from put warrant valuation	-	-	5,625
Change in operating assets and liabilities net of effects of acquisition:			
Accounts receivable, net	(1,637)	9,568	(4,663)
Inventories	640	(1,315)	(2,387)
Prepaid expenses	80	(773)	208
Income taxes	2,579	(3,227)	1,856
Accounts payable	1,360	3,832	(120)
Accrued sales returns	(596)	(141)	697
Accrued warranty costs	1,340	1,355	1,229
Accrued compensation, taxes and benefits	(173)	1,835	1,694
Other accrued liabilities	537	723	(265)
Other assets	535	147	252
Other liabilities	800	863	709
Net cash provided by (used in) operating activities	(10,286)	7,657	10,984
Cash flows used in investing activities:			
Purchases of property and equipment	(12,084)	(13,663)	(8,812)
Sales of (investments in) marketable securities	16,179	(20,129)	-
Investment in affiliate	(400)	(2,000)	-
Net cash provided by (used in) investing activities	3,695	(35,792)	(8,812)
Cash flows from financing activities:			
Principal payments on debt	(16)	(872)	(15,999)
Repurchase of common stock	-	(12,692)	-
Proceeds from issuance of common stock	664	3,579	46,718
Net cash provided by (used in) financing activities	648	(9,985)	30,719
Increase (decrease) in cash and cash equivalents	(5,943)	(38,120)	32,891
Cash and cash equivalents, at beginning of year	7,441	45,561	12,670
Cash and cash equivalents, at end of year	\$ 1,498	\$ 7,441	\$45,561
 SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION (NOTE 2)			
Cash paid during the year for:			
Interest	\$ 7	\$ 69	\$ 1,719
Income taxes	175	2,292	1,800
Cashless exercise of stock options	-	-	1,483
Net tax benefit from exercise of stock options	11	1,115	493
	\$ 193	\$ 2,486	\$ 5,505

See accompanying notes to consolidated financial statements.

SELECT COMFORT CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(1) BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

BUSINESS

Select Comfort Corporation and its wholly-owned subsidiaries (the Company) develop, manufacture, and market air beds and sleep-related products. The Company's fiscal year ends on the Saturday closest to December 31. Fiscal years 2000, 1999 and 1998 had 52 weeks. Certain prior-year amounts have been reclassified to conform to the current-year presentation.

PRINCIPLES OF CONSOLIDATION

The consolidated financial statements include the accounts of the Company and its subsidiaries. All significant inter-company balances and transactions have been eliminated in consolidation.

GOING CONCERN CONSIDERATIONS

The financial statements have been prepared on a going-concern basis, which contemplates the realization of assets and the satisfaction of liabilities and other commitments in the normal course of business. The Company has incurred negative cash flows and has incurred pretax losses from operations of \$25,970,000 and \$14,793,000 in 2000 and 1999, respectively. In addition, the Company had negative working capital of \$18,176,000 at December 30, 2000. These factors, among others, indicate that there is a substantial doubt about the Company's ability to continue as a going concern. These financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts or the amounts and classification of liabilities that might be necessary if it was unable to continue as a going concern. The Company's continuation as a going concern is dependent, among other things, upon obtaining positive cash flow from operations or upon its ability to raise additional working capital.

Near the end of 2000, the Company began to undertake efforts to right size its cost structure. The economic downturn at the end of 2000 adversely affected sales trends, resulting in the identification and execution of additional cost reduction measures. Efforts have included termination of non-core business initiatives, closure of certain facilities, including one of three manufacturing facilities, one of two administrative offices and one of two call centers, closure of 27 stores in 2000 with plans to close 14 stores in 2001, reduction of corporate and administrative overhead and staffing, and adjustment of advertising, promotional and other marketing programs. The Company is also pursuing programs to improve its liquidity, including negotiation of supplier and landlord payment terms, the reduction of inventory levels and the deferral of capital programs.

Since the fourth quarter of 2000, the Company has been pursuing \$10 million or more of working capital financing from a variety of potential sources. The Company is pursuing a private placement of \$10 million to \$12 million of senior secured debt securities convertible into shares of common stock together with detachable warrants to purchase additional shares of common stock. Consummation of this financing as contemplated could result in substantial dilution to current shareholders. Based on discussions with potential investors in this private placement, the Company believes that it will be able to consummate this financing. However, firm commitments have not been received and significant conditions to closing remain to be met, and therefore no assurance can be given that it will be able to consummate this financing on satisfactory terms, or at all.

While management believes that implementation of its plans to achieve profitability and obtain additional capital will provide sufficient working capital to fund operations for the foreseeable future, there is no assurance that such actions will achieve positive results from operations or adequate working capital and equity.

CASH AND CASH EQUIVALENTS

Cash and cash equivalents include highly liquid investments with original maturities of three months or less.

INVENTORIES

Inventories include material, labor, and overhead and are stated at the lower of cost or market. Cost is determined by the first-in, first-out method.

SELECT COMFORT CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(1) BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

PROPERTY AND EQUIPMENT

Property and equipment, carried at cost, are depreciated using the straight-line method over the estimated useful lives of the assets, which range from three to seven years. Leasehold improvements are amortized over the shorter of the life of the lease or ten years.

OTHER ASSETS

Other assets include security deposits, patents, investments, trademarks, debt issuance costs and goodwill. Patents and trademarks are amortized using the straight-line method over periods ranging from 10 to 17 years. Debt issuance costs are amortized using the straight-line method over the term of the debt. Goodwill is being amortized using the straight-line method over a 10-year period.

IMPAIRMENT OF LONG-LIVED ASSETS AND LONG-LIVED ASSETS TO BE DISPOSED OF

The Company reviews its long-lived assets and certain identifiable intangibles for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell. The Company reviews store assets for possible impairment considering such factors as store cash flows, lease termination provisions, and opportunities to impact future store operating results.

ACCRUED WARRANTY COSTS

The Company provides a 20-year warranty on air beds, the last 15 years of which are on a prorated basis. Estimated warranty costs are provided at the time of sale based on historical claims incurred by the Company. Given the limited history available, actual results could differ from these estimates.

ACCRUED SALES RETURNS

Estimated sales returns are provided at the time of sale based upon historical sales returns. Returns are allowed by the Company for 90 nights following the sale.

FAIR VALUE OF FINANCIAL INSTRUMENTS

The carrying value of cash and cash equivalents and accounts receivable approximate fair value because of the short-term maturity of those instruments. The fair value of long-term debt approximates carrying value based on the Company's estimate of rates that would be available to it for debt of the same remaining maturities.

REVENUE RECOGNITION

Revenue is recognized when products are shipped to customers net of estimated returns. The Company records shipping and handling costs as a component of sales and marketing expense.

STOCK COMPENSATION

The Company records compensation expense for option grants under its stock option plan if the current market value of the underlying stock at the grant date exceeds the stock option exercise price. Pro forma disclosure of the net income impact of applying an alternative method of recognizing stock compensation expense over the vesting period based on the fair value of all stock-based awards on the date of grant is presented in Note 9. The Company has issued options to non-employees and recognized compensation expense based on the fair market value method.

SELECT COMFORT CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(1) BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

RESEARCH AND DEVELOPMENT COSTS

Costs incurred in connection with research and development are charged to expense as incurred. Research and development expense was \$889,000, \$1,865,000 and \$1,638,000 in 2000, 1999 and 1998, respectively.

PRE-OPENING COSTS

Costs associated with the opening of new stores are expensed as incurred.

ADVERTISING COSTS

The Company incurs advertising costs associated with print and broadcast advertisements. Such costs are charged to expense as incurred. Advertising expense was \$33,444,000, \$43,415,000 and \$31,648,000 in 2000, 1999 and 1998.

INCOME TAXES

The Company recognizes deferred tax assets and liabilities for the future tax consequences attributable to temporary differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

EARNINGS PER SHARE

Basic earnings (loss) per share excludes dilution and is computed by dividing the net income (loss) available to common shareholders by the weighted average number of common shares outstanding during the period. Diluted earnings (loss) per share includes dilutive potential common shares consisting of stock options and warrants determined by the treasury stock method, and dilutive convertible securities.

ACCOUNTING ESTIMATES

The preparation of 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 and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

NEW ACCOUNTING PRONOUNCEMENTS

The Financial Accounting Standards Board has issued Statement of Financial Accounting Standards No 133, "Accounting for Derivative Instruments and Hedging Activities", which requires implementation during 2001. The Company has evaluated the impact of SFAS 133 and has determined that the pronouncement will not impact the Company's consolidated financial statements.

(2) ACQUISITION

Effective November 10, 2000, the Company completed the acquisition of certain assets of SleepTec, Inc. ("SleepTec"), the manufacturer of the Company's sofa sleeper product. The acquisition of SleepTec was accounted for by the purchase method of accounting. The Company made an original investment in SleepTec of \$2,000,000 in May 1999 and accounted for the less than 20% investment under the cost method. The subsequent acquisition in 2000 resulted in step-acquisition treatment of the original May 1999 investment. Accordingly, the results of operations of SleepTec for 1999, in the amount of the Company's ownership interest (15.7%) are included as an adjustment to 1999 retained earnings (\$502,000). The results of SleepTec's operations for 2000 are included in the Company's consolidated results as a loss in equity of affiliate (\$642,000) and amortization of goodwill related to this purchase transaction is included in general and administrative expense (\$46,000).

SELECT COMFORT CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(2) ACQUISITION (CONTINUED)

The aggregate purchase price paid by the Company for the assets of SleepTec consists of (i) a non-interest-bearing subordinated convertible debenture ("debenture") in the original principal amount of \$4,000,000, due November 10, 2005 and convertible at any time into shares of the Company's common stock at the rate of \$5.50 per share of common stock; and (ii) \$400,000 in cash. In addition, the Company agreed to fund approximately \$250,000 in a combination of cash and equity (in the form of options to purchase shares of the Company's common stock) payments to current and former employees of SleepTec for transition services and severance compensation. The Company's largest shareholder is the holder of the SleepTec debenture.

The purchase price was determined through arm's-length negotiations between the Company and representatives of SleepTec based primarily upon the past and projected stream of earnings of the SleepTec operations. The source of the funds used to pay the purchase price was cash on hand at the Company and by issuance of the debenture.

A summary of the assets acquired and the amount paid for this acquisition is as follows (in thousands):

Inventory	\$272
Property, plant and equipment	544
Patents and trademarks (amortized by the straight-line method over ten years)	50
Goodwill (amortized by the straight-line method over ten years)	2,864

Purchase price	3,730

Less:	
Amount previously paid for SleepTec, net of equity losses	(742)
Transaction costs, included in goodwill balance above	(318)
Value of \$4,000,000 non-interest bearing subordinated convertible debenture	(2,270)

Net cash paid	\$400
	=====

The asset and liability balances noted above, excluding cash paid, are treated as non-cash items in the statement of cash flows.

The value of the \$4,000,000 non-interest bearing subordinated convertible debenture was determined based on its net cash flows using a 12% discount rate and a five-year term.

Unaudited pro forma results of operations for the years ended December 30, 2000, and January 1, 2000, as if the Company and SleepTec had been combined as of the beginning of those years follows. The pro forma results include estimates and assumptions which management believes are reasonable. However, pro forma results do not include any cost savings or any other effects of the planned integration of the Company and SleepTec, and are not necessarily indicative of the results which would have occurred if the business combination had been in effect on the dates indicated, or which may result in the future.

(IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)	PRO FORMA	PRO FORMA
	DECEMBER 30, 2000	JANUARY 1, 2000
	-----	-----
Net sales	\$270,479	\$274,011
Net loss	(19,901)	(12,240)
Net loss per share - diluted	(1.12)	(0.67)
	=====	=====

SELECT COMFORT CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(3) MARKETABLE SECURITIES

Securities classified as held to maturity, which consist of securities that management has the ability and intent to hold to maturity, are carried at amortized cost, and are summarized as follows: (in thousands):

	AVERAGE INTEREST RATE	AMORTIZED COST	FAIR VALUE
DECEMBER 30, 2000			
Commercial paper	6.7%	3,950	3,949
		\$ 3,950	\$ 3,949
JANUARY 1, 2000			
U.S. Government agencies	5.5%	\$ 7,244	\$ 7,228
Commercial paper	5.8%	12,885	12,877
		\$20,129	\$20,105

(4) INVENTORIES

Inventories consist of the following (in thousands):

	DECEMBER 30, 2000	JANUARY 1, 2000
Raw materials	\$ 5,507	\$ 5,753
Work in progress	60	59
Finished goods	5,516	5,639
	\$11,083	\$11,451

(5) PROPERTY AND EQUIPMENT

Property and equipment are summarized as follows (in thousands):

	DECEMBER 30, 2000	JANUARY 1, 2000
Leasehold improvements	\$35,712	\$33,192
Office furniture and equipment	5,097	5,314
Production machinery and computer equipment	19,794	13,115
Property and equipment under capital lease	112	495
Other	188	1,108
Less accumulated depreciation and amortization	(23,840)	(17,401)
	\$37,063	\$34,823

STORE CLOSINGS AND ASSET IMPAIRMENT CHARGES

Store closing and write off expense was \$565,000, \$1,498,000, and \$20,000 in 2000, 1999 and 1998, respectively, associated with 16 stores, 22 stores and 1 store in 2000, 1999 and 1998 respectively.

During 2000, the Company incurred charges of \$1,387,000 related to the impairment of carrying values of certain non-store assets. These charges included \$741,000 related to relocation of the Company's headquarters and \$646,000 related to the write-off of web software design costs.

SELECT COMFORT CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(6) LEASES

The Company rents office and manufacturing space under four operating leases which, in addition to the minimum lease payments, require payment of a proportionate share of the real estate taxes and building operating expenses. The Company also rents retail space under operating leases which, in addition to the minimum lease payments, require payment of percentage rents based upon sales levels. Rent expense was as follows:

	2000	1999	1998
Minimum rents	\$17,589	\$15,399	\$11,127
Percentage rents	1,835	1,992	1,522
Total	\$19,424	\$17,391	\$12,649
Equipment rent	\$ 1,587	\$ 1,362	\$ 952

The aggregate minimum rental commitments under operating leases for subsequent years are as follows (in thousands):

2001	\$15,376
2002	15,088
2003	14,311
2004	12,853
2005	11,308
Thereafter	24,143

	\$93,079
	=====

(7) LONG-TERM DEBT AND CAPITAL LEASE OBLIGATIONS

Long-term obligations under notes and capital leases are as follows (in thousands):

	DECEMBER 30, 2000	JANUARY 1, 2000
Non-interest bearing subordinated convertible debenture for the acquisition of certain assets of SleepTec, Inc. due November 2005. Face amount of \$4,000,000 net of \$1,711,000 debt discount, with an effective interest rate of 12% per annum. Convertible into 727,273 shares of common stock at the rate of \$5.50 per share (note 2).	\$2,289	\$ -
Notes payable under capital lease agreements for office equipment, payable in monthly installments through April 2003, with interest at 7.75% - 12.5% per annum.	71	87
Less current maturities	2,360	87
	38	51
	-----	-----
	\$2,322	\$36
	=====	=====

The aggregate maturities of long-term debt and capital lease obligations for subsequent years are as follows (in thousands):

2001	\$ 38
2002	28
2003	5
2004	-
2005	4,000
Thereafter	-

	\$4,071
	=====

SELECT COMFORT CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(7) LONG-TERM DEBT AND CAPITAL LEASE OBLIGATIONS (CONTINUED)

In March 1997, the Company completed a financing under which it issued a senior subordinated promissory note in the principal amount of \$15,000,000, a warrant to purchase 1,100,000 shares of the Company's common stock at \$10.50 per share and a warrant to purchase 1,000,000 shares of common stock at \$0.01 per share. These warrants were subsequently adjusted and combined, resulting in a single warrant to purchase 1,315,096 shares of common stock at \$8.82 per share, exercisable at any time prior to March 31, 2005. The holder has exercised 238,998 warrants to date. This warrant includes an anti-dilution provision resulting in warrants outstanding of 1,131,357 at \$8.39 and 1,083,391 at \$8.76 at December 30, 2000 and January 1, 2000, respectively.

In December 1998, the Company repaid the promissory note resulting in an extraordinary loss of \$1,441,000 from early repayment. The loss was comprised of unamortized debt discount and issuance costs totaling \$2,281,000, and net of income tax benefits of \$840,000.

The original warrant issued in the financing provided that the holder could require repurchase of the warrant if an IPO had not been completed prior to March 27, 2002. The repurchase amount would have been equal to the excess of the estimated fair market value of the Company's common stock, as determined by the warrant agreement, over the exercise price of the warrant. The Company also has an option to repurchase the warrant if the warrant has not been exercised prior to March 27, 2004. The warrant was recorded at fair value and recorded as long-term debt. Changes in fair value of the warrant were reflected as interest expense. Accordingly, the financial statements reflect interest expense of \$5,625,000 for 1998 related to this warrant.

Upon completion of the Company's initial public offering the put option on the warrants expired and the warrants were reclassified into \$9,215,000 of additional paid-in-capital. In addition, effective upon completion of the Company's initial public offering, warrant revaluation is no longer required and accordingly interest expense is no longer recorded.

(8) MANDATORILY REDEEMABLE PREFERRED STOCK

Prior to completion of the Company's initial public offering in December 1998, the Company had issued and outstanding 12,091,962 shares of mandatorily redeemable preferred stock. The holders of the Series A, B, C, D, and E mandatorily redeemable preferred stock had certain rights and preferences, including those involving dividend participation, special voting, liquidation preferences, antidilution rights, redemption rights and in certain cases, those involving cumulative dividends.

In November 1998, the Company adjusted the conversion price of the Series E Mandatorily Redeemable Preferred Stock from \$8.82 per share to \$8.20. The adjustment was made in accordance with the Series E Stock Purchase Agreement and was effective on the closing of the Company's initial public offering. The adjustment resulted in the issuance of an additional 77,155 shares of common stock upon conversion. For purposes of calculating net income per share in the period in which the initial public offering was completed, net income available to common shareholders has been reduced by \$1,312,000 in 1998 for the estimated value of additional shares issued under these antidilution provisions (note 11).

Upon completion of the Company's underwritten public offering in December 1998 the Series A, B, C, D, and E mandatorily redeemable preferred stock were converted into an aggregate of 12,332,364 of common stock. In addition, all rights and preferences, including those involving cumulative dividends expired. Cumulative but undeclared and unpaid dividends have been deducted from net income available to common shareholders in determining net income per share (note 11).

As of January 2, 1999, there were no remaining shares of mandatory redeemable shares outstanding.

Changes in mandatorily redeemable preferred stock are as follows (dollars in thousands):

	SHARES	AMOUNT	ADDITIONAL PAID-IN CAPITAL	TOTAL
Balance at January 3, 1998	12,091,962	\$12,692	\$14,920	\$27,612
Conversion to common stock	12,091,962	12,692	14,920	27,612
Balance at January 2, 1999	-	\$ -	\$ -	\$ -

=====

SELECT COMFORT CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(9) SHAREHOLDERS' EQUITY

Effective December 4, 1998, the Company issued 2,922,350 common shares in completion of its initial public offering resulting in net proceeds of \$44,643,000.

STOCK OPTIONS

The Board of Directors has reserved 6,300,000 shares of common stock for options that may be granted to key employees, directors, or others under the Company's stock option plans.

A summary of the changes in the Company's stock option plans for each of the years in the three-year period ended December 30, 2000 is as follows:

	SHARES	WEIGHTED AVERAGE EXERCISE PRICE
Outstanding at January 3, 1998 (including 931,319 shares exercisable)	2,095,609	\$ 4.98
Granted	443,075	14.70
Exercised	(526,880)	3.18
Canceled	(208,070)	5.82
Outstanding at January 2, 1999 (including 884,807 shares exercisable)	1,803,734	7.77
Granted	1,857,100	12.10
Exercised	(448,705)	5.05
Canceled	(526,776)	14.66
Outstanding at January 1, 2000 (including 1,311,133 shares exercisable)	2,685,353	9.92
Granted	1,307,700	4.64
Exercised	(44,515)	3.09
Canceled	(429,267)	9.44
Outstanding at December 30, 2000 (including 1,726,097 shares exercisable)	3,519,271	\$ 8.08

The following table summarizes information about options outstanding at December 30, 2000:

OPTIONS OUTSTANDING				OPTIONS EXERCISABLE		
RANGE OF EXERCISE PRICE	SHARES	AVERAGE REMAINING CONTRACTUAL LIFE (YEARS)	WEIGHTED AVERAGE EXERCISE PRICE	SHARES	WEIGHTED AVERAGE EXERCISE PRICE	
\$0.45 - 4.80	706,927	8.27	\$3.34	335,085	\$3.61	
4.82 - 5.91	1,277,687	8.26	5.55	484,978	5.41	
6.63 - 11.00	792,872	8.05	8.19	567,567	8.54	
13.94 - 24.50	706,785	8.24	16.38	307,787	16.69	
24.53 - 28.63	35,000	8.25	26.54	30,680	26.56	
\$0.45 - 28.63	3,519,271	8.21	\$8.08	1,726,097	\$8.48	

SELECT COMFORT CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(9) SHAREHOLDERS' EQUITY (CONTINUED)

No compensation cost has been recognized in the consolidated financial statements for employee stock options grants. Had the Company determined compensation cost based on the fair value at the grant date for its stock options under an alternative accounting method, the Company's net income (loss) would have been adjusted as indicated below (in thousands):

		2000	1999	1998
		-----	-----	-----
Net income (loss):	As reported	\$(37,214)	\$ (8,204)	\$5,195
	Pro forma	\$(39,673)	\$(11,088)	\$4,144
Earnings (loss) per share:	As reported	\$ (2.09)	\$ (0.45)	\$ 1.09
	Pro forma	\$ (2.22)	\$ (0.60)	\$ 0.73

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model with the following assumptions: expected dividend yield-0%; expected stock price volatility-40%; risk-free interest rate-5.9%, 6.3%, and 4.6% for 2000, 1999 and 1998 respectively; expected life of options-3.6, 2.9 years, and 3.0 for 2000, 1999, 1998, respectively. The per share weighted-average fair value of stock options granted during 2000, 1999 and 1998 was \$1.87, \$3.86 and \$4.72, respectively.

WARRANTS

In April 1996, the Company issued warrants to the holders of Series E Preferred Stock (note 8) to purchase an aggregate of 171,429 shares of Common Stock at an exercise price of \$5.25 per share. During 1998, warrants for 54,430 common shares were exercised. Warrants for 108,499 shares remained outstanding at December 30, 2000 and January 1, 2000, respectively.

In connection with a capital lease transaction with a vendor in 1997, the Company granted the vendor warrants to acquire 31,428 shares of the Company's Series E convertible preferred stock at a purchase price of \$10.50 per share. The warrants are exercisable for five years beginning December 3, 1998. In December 1998 all the Preferred Stock warrants were converted into warrants exercisable into 40,243 shares of common stock at \$8.20 per share. In February of 1999, the vendor exercised all of these warrants.

In connection with short-term debt issued to related parties in 1996, the Company granted warrants to purchase 71,525 shares of the Company's common stock at a purchase price of \$5.25 per share. The warrants are exercisable for ten years from the grant date. During December 1998, warrants for 7,003 common shares were exercised. Warrants for 64,522 shares remained outstanding at December 30, 2000 and January 1, 2000.

In connection with an executive search in March 2000, the Company issued warrants to purchase 40,000 shares of the Company's common stock at a purchase price of \$5.56 per share. The warrants are exercisable for five years from the grant date. All of these warrants remained outstanding at December 30, 2000.

STOCK REPURCHASE

During 1999, the Company repurchased 1,220,000 shares for approximately \$12.7 million.

SELECT COMFORT CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(10) INCOME TAXES

The provision (benefit) for income taxes consists of the following (in thousands):

	2000	1999	1998
Current:			
Federal	\$ -	\$ -	\$ 2,969
State	705	180	687
Deferred:			
Federal	10,397	(4,694)	(5,803)
State	490	(304)	(85)
	10,887	(4,998)	(5,888)
Income tax expense (benefit)	\$11,592	\$(4,818)	\$(2,232)

Effective tax rates differ from statutory federal income tax rates as follows:

	2000	1999	1998
Statutory federal income tax rate	(35.0%)	(35.0%)	35.0%
Nondeductible interest expense, put warrants	0.0	0.0	44.7
Change in valuation allowance	82.2	0.0	(147.0)
Effect of change in tax rate on deferred tax asset	0.0	0.0	6.7
State income taxes, net of federal benefit	(1.1)	(0.6)	8.9
Other	(0.9)	(1.4)	1.0
	45.2%	(37.0%)	(50.7%)

The tax effects of temporary differences that give rise to deferred tax assets at December 30, 2000 and January 1, 2000 are as follows (in thousands):

	2000	1999
Deferred tax assets:		
Current:		
Inventory, warranty, and returns reserves	\$ 5,012	\$ 4,553
Allowance for doubtful accounts	100	116
Other	2,171	1,970
Long term:		
Net operating loss carryforwards	11,923	3,885
Other	2,389	886
Total gross deferred tax assets	21,595	11,410
Valuation allowance	(21,595)	(523)
Total net deferred tax assets	\$ -	\$10,887

At December 30, 2000, the Company had net operating loss carryforwards ("NOLs") for federal income tax purposes of approximately \$31,400,000 expiring between the years 2003 and 2020. The Company expects that approximately \$1,400,000 of these NOLs will expire unutilized due to an Internal Revenue Code (IRC) Section 382 limitation resulting from a prior ownership change and has, therefore, provided a valuation allowance for this portion of the carryforwards. During the fourth quarter of fiscal 2000 the Company increased its valuation allowance by \$21,072,000 due to negative cash flows, recurring pre-tax operating losses and the recent downturn of the economy making realization of the deferred tax assets uncertain.

SELECT COMFORT CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(11) NET INCOME (LOSS) PER COMMON SHARE

The following computations reconcile net income (loss) with net income (loss) per common share-basic and diluted (dollars in thousands, except per share amounts).

2000	NET LOSS	SHARES	PER SHARE AMOUNT
Net loss	(\$37,214)		
BASIC AND DILUTED EPS			
Net loss attributable to common shareholders	(\$37,214)	17,848,375	(\$2.09)

1999	NET LOSS	SHARES	PER SHARE AMOUNT
Net loss	(\$8,204)		
BASIC AND DILUTED EPS			
Net loss attributable to common shareholders	(\$8,204)	18,299,728	(\$0.45)

1998	NET INCOME	SHARES	PER SHARE AMOUNT
Net income before extraordinary item	\$6,636		
Less: Deemed dividend from revision of preferred stock	(1,312)	-	
Cumulative preferred dividends	(821)	-	
BASIC EPS			
Net income available to common shareholders	\$4,503	4,114,219	\$1.09
EFFECT OF DILUTIVE SECURITIES			
Options	-	912,448	
Warrants	-	654,436	
Convertible preferred stock	-	10,247,143	
DILUTED EPS			
Net income attributable to common shareholders plus assumed conversion	\$4,503	15,928,246	\$0.28

The following is a summary of those securities outstanding during the respective periods which have been excluded from the calculations because the effect on net income (loss) per common share would not have been dilutive:

	2000	1999	1998
Options	3,519,271	2,722,429	-
Common stock warrants	1,344,378	1,249,119	-

SELECT COMFORT CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(12) EMPLOYEE BENEFIT PLANS

Effective January 1, 1994, the Company adopted a profit sharing and 401(k) plan for eligible employees. The plan allows employees to defer up to 15% of their compensation on a pretax basis. Each year, the Company may make a discretionary contribution equal to a percentage of the employee's contribution. During 2000, 1999 and 1998, the Company expensed \$487,000, \$480,000 and \$375,000, respectively, relating to its contribution to the 401(k) plan.

EMPLOYEE STOCK PURCHASE PLAN

Effective July 30, 1999, the Company adopted an Employee Stock Purchase Plan (the "Plan") under which employees can purchase Company common stock at a discount of 15% based on the average price of the stock on the last business day of the offering period (calendar-quarter). 204,927 and 17,705 shares were issued during 2000 and 1999, respectively.

(13) RELATED PARTY TRANSACTIONS

The Company has entered into a consulting agreement with a director of the Company beginning May 4, 1999. The agreement is effective for a term of two years, provides an annual fee of \$100,000 and 60,000 options vesting over three years. In 1999, the Company expensed \$44,000 relating to these options. Effective January 2000, the director resigned from the board terminating the agreement. An aggregate of 27,292 vested options are exercisable through May 2004.

(14) COMMITMENTS AND CONTINGENCIES

The Company and certain of its former officers and directors have been named as defendants in a class action lawsuit filed on behalf of Company shareholders in U.S. District Court in Minnesota. The named plaintiffs, who purport to act on behalf of a class of purchasers of the Company's common stock during the period from December 4, 1998 to June 7, 1999, charge the defendants with violations of federal securities laws. The suit alleges that the Company and the named directors and officers failed to disclose or misrepresented certain information concerning the Company during the class period. The complaint does not specify an amount of damages claimed. The Company believes that the complaint is without merit and intends to vigorously defend the claims.

The Company and the individual defendants brought a motion to dismiss all claims on November 10, 1999. The motion was heard by a magistrate judge on December 21, 1999. On January 27, 2000, the magistrate recommended that the claims based on Section 11 of the federal securities laws be dismissed. The magistrate recommended that the motion to dismiss be denied with respect to the claims based on Rule 10b-5 of the federal securities laws. In February 2000, both the plaintiffs and the defendants formally objected to the magistrate's recommendation. The objection was made to the United States District Court in Minnesota. On May 12, 2000, the United States District Court in Minnesota adopted the recommendation of the magistrate and denied the defendants' motion to dismiss the Rule 10b-5 claims. The Court also adopted the recommendation of the magistrate and dismissed the plaintiff's Section 11 claims without prejudice and with leave to amend.

On March 31, 2000, the Company and certain of its former officers and directors were named as defendants in a class action lawsuit filed on behalf of the Company's shareholders in U.S. District Court in Minnesota asserting identical factual allegations as the consolidated complaint described above. The suit alleges claims based on Sections 11 and 12(a)(2) of the federal securities laws. The complaint does not specify an amount of damages claimed. The Company believes this complaint is without merit and intends to vigorously defend the claims. The above two class actions were consolidated by the United States District Court Magistrate on July 24, 2000.

SELECT COMFORT CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(14) COMMITMENTS AND CONTINGENCIES (CONTINUED)

The Company is a party to other various claims, legal actions, sales tax disputes, and other complaints arising in the ordinary course of business. In the opinion of management, any losses that may occur are adequately covered by insurance or are provided for in the consolidated financial statements and the ultimate outcome of these matters will not have a material effect on the consolidated financial position or results of operations of the Company.

(15) SUMMARY OF QUARTERLY FINANCIAL DATA (UNAUDITED)

The following is a condensed summary of actual quarterly results for 2000 and 1999:

2000 ----	Fourth	Third	Second	First
Net sales	\$64,075	\$68,056	\$61,787	\$76,159
Gross margin	39,054	43,185	39,901	49,013
Operating loss	(6,905)	(8,894)	(5,391)	(4,780)
Net loss	(25,059)	(5,692)	(3,465)	(2,998)
Net loss per share - diluted	(1.39)	(0.32)	(0.19)	(0.17)
1999 ----	Fourth	Third	Second	First
Net sales	\$68,104	\$68,281	\$65,750	\$71,632
Gross margin	44,050	44,337	43,188	47,085
Operating income (loss)	(9,939)	(6,432)	200	1,378
Net income (loss)	(6,042)	(3,698)	348	1,188
Net income (loss) per share - diluted	(0.33)	(0.20)	0.02	0.06

MANAGEMENT'S REPORT

The management of Select Comfort Corporation is responsible for the preparation, integrity and fair presentation of the consolidated financial statements included in this annual report. The financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America and include amounts based on judgments and estimates made by management. Management is also responsible for the preparation and accuracy of information included in other sections of this annual report, which information is consistent with the financial statements.

The integrity of the financial statements is based on the maintenance of an internal control structure established by management to provide reasonable assurance that assets are safeguarded and transactions are properly authorized, recorded and reported. The concept of reasonable assurance is based on the recognition that the cost of maintaining a system of internal controls should not exceed the benefits expected to be derived. Even effective internal controls, no matter how well designed, have inherent limitations. Management believes that the internal control system provides reasonable assurance that errors or irregularities that could be material to the financial statements are prevented or would be detected and corrected in the normal course of business.

The Company engages independent auditors to examine its financial statements and express their opinion thereon. The auditors have access to each member of management in conducting their audits. Their report appears in this annual report.

The Audit Committee of the Board of Directors, composed solely of non-management directors, meets periodically with management and the independent auditors to review internal accounting control, audit activities and financial reporting matters. The independent auditors have full access to the Audit Committee and meet periodically with them without management present.

/s/William R. McLaughlin

William R. McLaughlin
President and Chief
Executive Officer

/s/James C. Raabe

James C. Raabe
Chief Financial Officer

INDEPENDENT AUDITORS' REPORT ON FINANCIAL STATEMENT SCHEDULE

The Board of Directors and Stockholders
 Select Comfort Corporation:

Under date of February 2, 2001, except as to Notes 1 and 10 which are as of April 12, 2001, we reported on the consolidated balance sheets of Select Comfort Corporation and subsidiaries as of December 30, 2000 and January 1, 2000 and the related statements of operations, shareholders' equity, and cash flows for each of the years in the three-year period ended December 30, 2000, as contained in the Annual Report on Form 10-K for the year 2000. In connection with our audits of the aforementioned consolidated financial statements, we also audited the related financial statement schedule as listed in the accompanying index. This financial statement schedule is the responsibility of the Company's management. Our responsibility is to express an opinion on this financial statement schedule based on our audits.

In our opinion, such financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

The audit report on the consolidated financial statements of Select Comfort Corporation and subsidiaries referred to above contains an explanatory paragraph that states that the Company has negative cash flows that raise substantial doubt about the entity's ability to continue as a going concern. The financial statements and schedule included in the Company's 2000 Annual Report on Form 10-K do not include adjustments that might result from the outcome of this uncertainty.

/s/ KPMG LLP

Minneapolis, Minnesota
 February 2, 2001

SELECT COMFORT CORPORATION AND SUBSIDIARIES
 SCHEDULE II - VALUATION AND QUALIFYING ACCOUNTS
 (IN THOUSANDS)

DESCRIPTION	BALANCE AT BEGINNING OF PERIOD	ADDITIONS CHARGED TO COSTS AND EXPENSES	DEDUCTIONS FROM RESERVES	BALANCE AT END OF PERIOD
Allowance for doubtful accounts				
- 2000	\$ 305	\$ 531	\$ 572	\$ 264
- 1999	2,750	1,193	3,638	305
- 1998	1,901	2,794	1,945	2,750
Accrued warranty costs				
- 2000	\$5,841	\$5,397	\$4,057	\$7,181
- 1999	4,486	5,368	4,013	5,841
- 1998	3,257	4,807	3,578	4,486

SELECT COMFORT CORPORATION
1999 EMPLOYEE STOCK PURCHASE PLAN
(As Amended through February 13, 2001)

1. PURPOSE.

The purpose of this 1999 Employee Stock Purchase Plan (the "Plan") is to advance the interests of Select Comfort Corporation (the "Company") and its shareholders by allowing eligible employees of the Company and its Participating Subsidiaries to use payroll deductions to acquire shares of the Company's Common Stock on favorable terms. The Company intends that the Plan qualify as an "employee stock purchase plan" under Section 423 of the Code. Accordingly, provisions of the Plan will be construed so as to extend and limit participation in a manner consistent with the requirements of Section 423 of the Code.

2. DEFINITIONS.

2.1 "BOARD" means the Board of Directors of the Company.

2.2 "CHANGE IN CONTROL" means an event described in Section 9.1 of the Plan.

2.3 "CODE" means the Internal Revenue Code of 1986, as amended.

2.4 "COMMITTEE" means the group of individuals administering the Plan, as provided in Section 3 of the Plan.

2.5 "COMMON STOCK" means the common stock, par value \$0.01 per share, of the Company, or the number and kind of shares of stock or other securities into which such common stock may be changed in accordance with Section 4.3 of the Plan.

2.6 "COMPENSATION" means all gross cash compensation (including wage, salary, incentive, bonus and overtime earnings) paid by the Company or any Participating Subsidiary to a Participant, including amounts that would have constituted compensation but for a Participant's election to defer or reduce compensation pursuant to any deferred compensation, cafeteria, capital accumulation or any other similar plan of the Company; provided, however, that the Committee, in its sole discretion, may expand or limit the amounts that will be deemed compensation for purposes of the Plan in such manner as it deems appropriate.

2.7 "ELIGIBLE EMPLOYEE" means any employee of the Company or a Participating Subsidiary (other than an employee whose customary employment with the Company or a Participating Subsidiary is for five months or less per calendar year) who, with respect to any Offering Period, is employed by the Company or a Participating Subsidiary prior to the Offering Commencement Date for such Offering Period.

2.8 "EXCHANGE ACT" means the Securities Exchange Act of 1934, as amended.

2.9 "FAIR MARKET VALUE" means, with respect to the Common Stock, as of any date (or, if no shares were traded or quoted on such date, as of the next preceding date on which there

was such a trade or quote) (a) the mean between the reported high and low sale prices of the Common Stock if the Common Stock is listed, admitted to unlisted trading privileges or reported on any foreign or national securities exchange or on the Nasdaq National Market or an equivalent foreign market on which sale prices are reported; (b) if the Common Stock is not so listed, admitted to unlisted trading privileges or reported, the closing bid price as reported by the Nasdaq SmallCap Market, OTC Bulletin Board, National Quotation Bureau, Inc. or other comparable service; or (c) if the Common Stock is not so listed or reported, such price as the Committee determines in good faith in the exercise of its reasonable discretion.

2.10 "OFFERING COMMENCEMENT DATE" means the first day of an Offering Period.

2.11 "OFFERING PERIOD" means any of the offerings to Participants of Options under the Plan, each continuing for three months, as described in Section 6 of the Plan.

2.12 "OFFERING TERMINATION DATE" means the last day of an Offering Period.

2.13 "OPTION" means a right to purchase shares of Common Stock granted to a Participant in connection with an Offering Period pursuant to Section 7 of the Plan

2.14 "OPTION PRICE" means, with respect to any Offering Period, 85% of the Fair Market Value of one share of Common Stock on the Offering Termination Date.

2.15 "PARTICIPANT" means an Eligible Employee who elects to participate in the Plan pursuant to Section 5 of the Plan.

2.16 "PARTICIPATING SUBSIDIARY" means a Subsidiary that has been designated by the Committee from time to time, in its sole discretion, as a corporation whose Eligible Employees may participate in the Plan.

2.17 "SECURITIES ACT" means the Securities Act of 1933, as amended.

2.18 "SUBSIDIARY" means any subsidiary corporation of the Company within the meaning of Section 424(f) of the Code.

2.19 "TERMINATION OF EMPLOYMENT" means a Participant's complete termination of employment with the Company and all Participating Subsidiaries for any reason, including without limitation death, disability or retirement. In the event that a Participant is in the employ of a Participating Subsidiary and the Participating Subsidiary ceases to be a Participating Subsidiary of the Company for any reason, such event will be deemed a termination of employment unless the Participant continues in the employ of the Company or another Participating Subsidiary.

3. ADMINISTRATION.

The Plan will be administered by the Board or by a committee of the Board. So long as the Company has a class of its equity securities registered under Section 12 of the Exchange Act, any committee administering the Plan will consist solely of two or more members of the Board who are "non-employee directors" within the meaning of Rule 16b-3 under the Exchange Act.

Such a committee, if established, will act by majority approval of the members (at a meeting in person or by telephone conference or by written consent), and a majority of the members of such a committee will constitute a quorum. As used in the Plan, "Committee" will refer to the Board or to such a committee, if established. To the extent consistent with corporate law, the Committee may delegate to any officers of the Company the duties, power and authority of the Committee under the Plan pursuant to such conditions or limitations as the Committee may establish; provided, however, that only the Committee may exercise such duties, power and authority with respect to Participants who are subject to Section 16 of the Exchange Act. The Committee may exercise its duties, power and authority under the Plan in its sole discretion without the consent of any Participant or other party, unless the Plan specifically provides otherwise. Each determination, interpretation or other action made or taken by the Committee pursuant to the provisions of the Plan will be final, conclusive and binding for all purposes and on all persons, including, without limitation, the Company, the shareholders of the Company, the participants and their respective successors-in-interest. No member of the Committee will be liable for any action or determination made in good faith with respect to the Plan or any Option granted under the Plan.

4. SHARES AVAILABLE FOR ISSUANCE; ADJUSTMENTS FOR CERTAIN EVENTS.

4.1 MAXIMUM NUMBER OF SHARES AVAILABLE. Subject to adjustment as provided in Section 4.3 of the Plan, the maximum number of shares of Common Stock available for issuance under the Plan will be 1,000,000 shares of Common Stock. If the total number of shares of Common Stock that would otherwise be issuable upon the exercise of Options granted pursuant to Section 7 of the Plan on any Offering Termination Date exceeds the number of shares then available for issuance under the Plan, the Committee will make a pro rata allocation of the shares of Common Stock remaining available for issuance under the Plan in as uniform and equitable a manner as it deems appropriate.

4.2 ACCOUNTING FOR OPTIONS. Shares of Common Stock that are issued under the Plan or that are subject to outstanding Options will be applied to reduce the maximum number of shares of Common Stock remaining available for issuance under the Plan. Any shares of Common Stock that are subject to an Option that is terminated unexercised will automatically again become available for issuance under the Plan.

4.3 ADJUSTMENTS TO SHARES AND OPTIONS. In the event of any reorganization, merger, consolidation, recapitalization, liquidation, reclassification, stock dividend, stock split, combination of shares, rights offering, divestiture or extraordinary dividend (including a spin-off) or any other change in the corporate structure or shares of the Company, the Committee (or, if the Company is not the surviving corporation in any such transaction, the board of directors of the surviving corporation) will make appropriate adjustment (which determination will be conclusive) as to the number and kind of securities or other property (including cash) available for issuance or payment under the Plan and, in order to prevent dilution or enlargement of the rights of Participants, the number and kind of securities or other property (including cash) subject to, and the exercise price of, outstanding Options.

5. PARTICIPATION; PAYROLL DEDUCTIONS.

5.1 PARTICIPATION. Participation in the Plan is voluntary and is not a condition of employment. Eligible Employees may elect to participate in the Plan, beginning with the first Offering Period to commence after such person becomes an Eligible Employee, by properly completing an enrollment form in the form provided by the Company and filing the enrollment form with the Company's Human Resources Department not later than the 15th day of the month immediately preceding the Offering Commencement Date of the first Offering Period in which the Participant wishes to participate (or on such later date prior to the first Offering Period after adoption of the Plan as may be reasonably necessary to enable Eligible Employees to participate in such first Offering Period). An Eligible Employee who elects to participate with respect to an Offering Period will be deemed to have elected to participate in each subsequent Offering Period, unless such Participant properly withdraws from participation on a timely basis. An Eligible Employee may withdraw from participation as to any subsequent Offering Period by properly completing a notice of withdrawal in the form provided by the Company and filing the notice of withdrawal with the Company's Human Resources Department not later than 4:30 p.m., Minneapolis, Minnesota time on the 15th day of the last month of an Offering Period. Any such notice of withdrawal will be effective for the next Offering Period commencing after the Offering Period in which such notice of withdrawal is given, all as further described in Section 8.1 of the Plan.

5.2 LIMITATION ON PARTICIPATION. Notwithstanding any provisions of the Plan to the contrary, an Eligible Employee may not participate in the Plan and will not be granted an Option under the Plan if, immediately after the grant of such Option, such Eligible Employee (or any other person whose stock ownership would be attributed to such Eligible Employee pursuant to Section 424(d) of the Code) would own stock or options possessing 5% or more of the total combined voting power or value of all classes of stock of the Company or of its "parent" or "subsidiary" corporations (within the meaning of Section 424 of the Code).

5.3 PAYROLL DEDUCTIONS.

(a) By completing and filing an enrollment form, a Participant will elect to have payroll deductions made from such Participant's total Compensation in whole percentages from a minimum of 1% to a maximum of 15%, (or such other minimum or maximum percentages as the Committee may from time to time (a) establish).

(b) All payroll deductions authorized by a Participant will be credited as of each payday to an account established under the Plan for the Participant. Such account will be solely for bookkeeping purposes, no separate fund, trust or other segregation of such amounts will be established or made and the amounts represented by such account will be held as part of the Company's general assets, usable for any corporate purpose. A Participant may not make any separate cash payment or contribution to such Participant's account. No interest will accrue on amounts held in such accounts under the Plan.

(c) No increases or decreases in the amount of payroll deductions for a Participant may be made during an Offering Period. A Participant may increase or decrease the amount of his or her payroll deductions under the Plan for subsequent

Offering Periods by properly completing an amended enrollment form and filing it with the Company's Human Resources Department not later than the 15th day of the month immediately preceding the Offering Commencement Date of the Offering Period for which such change in payroll deductions is to be effective.

(d) A Participant may withdraw from participation in the Plan as provided in Section 8.1 of the Plan.

6. OFFERING PERIODS.

Options to purchase shares of Common Stock will be offered to Participants under the Plan through a continuous series of Offering Periods, each continuing for three months, and each of which will commence on January 1, April 1, July 1 and October 1 of each year, as the case may be, and will terminate on March 31, June 30, September 30 and December 31 of such year, as the case may be.

7. OPTIONS.

7.1 GRANT OF OPTIONS. With respect to any Offering Period, each Participant participating in such Offering Period will be granted, by operation of the Plan on the Offering Commencement Date for such Offering Period, an Option to purchase (at the Option Price) as many full shares of Common Stock as such Participant will be able to purchase with the accumulated payroll deductions credited to such Participant's account during such Offering Period plus the balance (if any) carried forward from the Participant's payroll deduction account from the preceding Offering Period.

7.2 LIMITATIONS ON PURCHASE. Notwithstanding Section 7.1 or any other provision of the Plan to the contrary, the number of shares of Common Stock that may be purchased under the Plan will be limited as follows:

(a) No Participant may purchase more than 2,000 shares of Common Stock under the Plan in any given Offering Period.

(b) No Participant may be granted an Option that permits such Participant's right to purchase Common Stock under the Plan and any other "employee stock purchase plans" (within the meaning of Section 423 of the Code) of the Company and its Subsidiaries to accrue (i.e., become exercisable) at a rate that exceeds \$25,000 of Fair Market Value of Common Stock (determined at the time such Option is granted) for each calendar year in which such Option is outstanding at any time.

7.3 EXERCISE OF OPTIONS.

(a) Unless a Participant withdraws from the Plan as provided in Section 8.1 of the Plan, the Participant's Option for the purchase of shares of Common Stock granted with respect to an Offering Period will be exercised automatically at the Offering Termination Date of such Offering Period for the purchase of the number of full shares of

Common Stock that the accumulated payroll deductions in such Participant's account as of such Offering Termination Date will purchase at the applicable Option Price.

(b) A Participant may only purchase one or more full shares in connection with the exercise of an Option granted for any Offering Period. The portion of any balance remaining in a Participant's payroll deduction account at the close of business on the Offering Termination Date of any Offering Period that is less than the Option Price of one full share of Common Stock will be carried forward into the Participant's payroll deduction account for the following Offering Period. In no event, however, will the balance carried forward be equal to or greater than the Option Price of one full share of Common Stock on the Offering Termination Date of an Offering Period.

(c) No Participant (or any person claiming through such Participant) will have any interest in any Common Stock subject to an Option under the Plan until such Option has been exercised, at which point such interest will be limited to the interest of a purchaser of the Common Stock purchased upon such exercise pending the delivery of such Common Stock.

(d) Shares of Common Stock acquired by each Participant shall be held in a general securities brokerage account maintained for the benefit of all Participants with a registered securities broker/dealer selected by the Company (the "Agent"). The Agent shall maintain individual subaccounts for each Participant in such general account to which shall be allocated such Participant's shares of Common Stock. The Committee, in its discretion, may direct the Agent to issue and deliver to any Participant a certificate or certificates for the whole number of shares of Common Stock held in such Participant's subaccount at any time ninety (90) days or more after the Participant ceases to be an Eligible Employee, which certificates shall be registered in the name of the Participant or in the form directed by the Participant. No certificates for fractional shares will be issued. Instead, Participants will receive a cash distribution representing any fractional shares.

(e) Cash dividends with respect to a Participant's shares of Common Stock held in the general securities brokerage account maintained by the Agent shall automatically be reinvested in additional shares of Common Stock. The purchase price of any shares ("Reinvestment Shares") purchased through the reinvestment of dividends shall be the Fair Market Value of a share on the date such dividend is paid. There shall be allocated to each Participant's individual subaccount such Participant's Reinvestment Shares purchased with the dividend funds credited to such Participant.

(f) Each Participant shall be entitled to vote all shares held for the benefit of such Participant in the general securities brokerage account maintained by the Agent.

8. WITHDRAWAL FROM PLAN.

8.1 VOLUNTARY WITHDRAWAL.

(a) A Participant may, at any time on or before 4:30 p.m., Minneapolis, Minnesota time on the 15th day of the last month of an Offering Period, terminate his or

her participation in the Plan and withdraw all, but not less than all, of the payroll deductions credited during the applicable Offering Period to such Participant's account under the Plan by giving written notice of withdrawal to the Company's Human Resources Department. Such notice shall be substantially in the form of the notice of withdrawal provided by the Company and must state that the Participant wishes to terminate his or her participation in the Plan and request the withdrawal of all of the Participant's payroll deductions credited during the applicable Offering Period to such Participant's account under the Plan. Following the receipt by the Company of a timely notice of withdrawal, (a) all of the payroll deductions credited during the applicable Offering Period to such Participant's account under the Plan will be paid to such Participant as soon as practicable after receipt of the notice of withdrawal; (b) such Participant's Option for such Offering Period will automatically be canceled and will no longer be exercisable; and (c) payroll deductions under the Plan will (a) cease as soon as practicable after receipt of the notice of withdrawal and until such time, if any, that a valid and timely enrollment form is subsequently filed by such Participant.

(b) A Participant's voluntary withdrawal pursuant to this Section 8.1 will not have any effect upon such Participant's eligibility to participate in a subsequent Offering Period (so long as such Participant completes and files a new enrollment form pursuant to Section 5 of the Plan) or in any similar plan that may hereafter be adopted by the Company.

8.2 TERMINATION OF EMPLOYMENT.

(a) Upon the Termination of Employment of a Participant at any time, (a) all of the payroll deductions credited during the current Offering Period to such Participant's account under the Plan will be paid to such Participant (or, in the case of death, to the person or persons entitled thereto under Sections 10 and 11.3 of the Plan) as soon as practicable after the effective date of the Termination of Employment; (b) such Participant's Option for such Offering Period will automatically be canceled and will no longer be exercisable; and (c) payroll deductions under the Plan will cease as soon as practicable after the effective date of the Termination of Employment.

(b) Unless the Committee otherwise determines in its sole discretion, a Participant's employment will, for purposes of the Plan, be deemed to have terminated on the date recorded on the personnel or other records of the Company or the Participating Subsidiary for which the Participant provides employment, as determined by the Committee in its sole discretion based upon such records.

9. CHANGE IN CONTROL.

9.1 CHANGE IN CONTROL. For purposes of this Section 9, a "Change in Control" of the Company will mean the following:

(a) the sale, lease, exchange or other transfer, directly or indirectly, of substantially all of the assets of the Company (in one transaction or in a series of related transactions) to any Person (as defined below);

(b) the approval by the shareholders of the Company of any plan or proposal for the liquidation or dissolution of the Company;

(c) any Person, other than a Bona Fide Underwriter (as defined below), becomes after the effective date of the Plan the "beneficial owner" (as defined in Rule 13d-3 under the Exchange Act), directly or indirectly, of (i) 20% or more, but not more than 50%, of the combined voting power of the Company's outstanding securities ordinarily having the right to vote at elections of directors, unless the transaction resulting in such ownership has been approved in advance by the Continuity Directors (as defined below), or (ii) more than 50% of the combined voting power of the Company's outstanding securities ordinarily having the right to vote at elections of directors (regardless of any approval by the Continuity Directors);

(d) a merger or consolidation to which the Company is a party if the shareholders of the Company immediately prior to the effective time of such merger or consolidation have, solely on account of ownership of securities of the Company at such time, "beneficial ownership" (as defined in Rule 13d-3 under the Exchange Act), immediately following the effective time of such merger or consolidation, of securities of the surviving corporation representing (i) 50% or more, but not more than 80%, of the combined voting power of the surviving corporation's then outstanding securities ordinarily having the right to vote at elections of directors, unless such merger or consolidation has been approved in advance by the Continuity Directors, or (ii) less than 50% of the combined voting power of the surviving corporation's then outstanding securities ordinarily having the right to vote at elections of directors (regardless of any approval by the Continuity Directors); or

(e) the Continuity Directors cease for any reason to constitute at least a majority of the Board.

9.2 CHANGE IN CONTROL DEFINITIONS. For purposes of this Section 9:

(a) "Continuity Director" means any individual who was a member of the Board on the effective date of the Plan, while he or she is a member of the Board, and any individual who subsequently becomes a member of the Board whose election, or nomination for election by the Company's shareholders, was approved by a vote of at least a majority of the directors who are Continuity Directors (either by a specific vote or by approval of the proxy statement of the Company in which such individual is named as a nominee for director without objection to such nomination). For example, assuming that seven individuals comprise the entire Board as of the effective date of the Plan, if a majority of such individuals approved a proxy statement in which two different individuals were nominated to replace two of the individuals who were members of the Board as of the effective date of the Plan, these two newly elected directors would join the remaining five directors who were members of the Board as of the effective date of the Plan as Continuity Directors. Similarly, if subsequently a majority of these directors approved a proxy statement in which three different individuals were nominated to replace three other directors who were members of the Board as of the effective date of the Plan, these three newly elected directors would also become, along with the other four

directors, Continuity Directors. Individuals subsequently joining the Board could become Continuity Directors under the principles reflected in this example.

(b) "Bona Fide Underwriter" means a Person engaged in business as an underwriter of securities that acquires securities of the Company from the Company through such Person's participation in good faith in a firm commitment underwriting until the expiration of 40 days after the date of such acquisition.

(c) "Person" means any individual, corporation, partnership, group, association or other "person," as such term is used in Section 13(d) or Section 14(d) of the Exchange Act, other than the Company, any affiliate or any benefit plan sponsored by the Company or any affiliate. For this purpose, an affiliate is (i) any corporation at least a majority of whose outstanding securities ordinarily having the right to vote at elections of directors is owned directly or indirectly by the Company or (ii) any other form of business entity in which the Company, by virtue of a direct or indirect ownership interest, has the right to elect a majority of the members of such entity's governing body.

9.3 ADJUSTMENT OF OFFERING PERIOD. Without limiting the authority of the Committee under Sections 3, 4.3 and 13 of the Plan, if a Change in Control of the Company occurs, the Committee, in its sole discretion, may (a) accelerate the Offering Termination Date of the then current Offering Period and provide for the exercise of Options thereunder by Participants in accordance with Section 7.3 of the Plan, or (b) accelerate the Offering Termination Date of the then current Offering Period and provide that all payroll deductions credited to the accounts of Participants will be paid to Participants as soon as practicable after such Offering Termination Date and that all Options for such Offering Period will automatically be canceled and will no longer be exercisable.

10. DESIGNATION OF BENEFICIARY.

A Participant may file with the Company's Human Resources Department a written designation of a beneficiary who is to receive shares of Common Stock and cash, if any, under the Plan in the event of such Participant's death prior to delivery of such shares or cash to such Participant. The Participant may change such designation of beneficiary at any time by written notice to the Company's Human Resources Department. In the event of the death of a Participant in the absence of a valid designation of a beneficiary who is living at the time of such Participant's death, (a) the Company will deliver such shares of Common Stock and cash to the executor or administrator of the estate of the Participant, or (b) if to the Company's knowledge no such executor or administrator has been appointed, the Company, in its sole discretion, may deliver such shares of Common Stock and cash to the spouse or to any one or more dependents or relatives of the Participant or, if no spouse, dependent or relative is known to the Company, to such other person as the Company may designate.

11. RIGHTS OF ELIGIBLE EMPLOYEES AND PARTICIPANTS; TRANSFERABILITY.

11.1 NO RIGHT TO EMPLOYMENT. Nothing in the Plan will interfere with or limit in any way the right of the Company or any Participating Subsidiary to terminate the employment of any

Eligible Employee or Participant at any time, nor confer upon any Eligible Employee or Participant any right to continue in the employ of the Company or any Participating Subsidiary.

11.2 RIGHTS AS A SHAREHOLDER. As a holder of an Option under the Plan, a Participant will have no rights as a shareholder unless and until such Option is exercised and the Participant becomes the holder of record of shares of Common Stock. Except as otherwise provided in the Plan, no adjustment will be made for dividends or distributions with respect to Options as to which there is a record date preceding the date the Participant becomes the holder of record of such shares, except as the Committee may determine in its sole discretion.

11.3 RESTRICTIONS ON TRANSFER. Neither payroll deductions credited to a Participant's account nor any rights with regard to the exercise of an Option or to receive shares of Common Stock under the Plan may be assigned, transferred, pledged or otherwise disposed of in any way (other than by will, the laws of descent and distribution, or as provided in Section 10 of the Plan) by the Participant. Any such attempt at assignment, transfer, pledge or other disposition will be without effect, except that the Company may treat such act as an election to withdraw from the Plan in accordance with Section 8.1 of the Plan. During his or her lifetime, a Participant's Option to purchase shares of Common Stock under the Plan is exercisable only by such Participant.

12. SECURITIES LAW AND OTHER RESTRICTIONS.

Notwithstanding any other provision of the Plan or any agreements entered into pursuant to the Plan, the Company will not be required to issue any shares of Common Stock under the Plan, and a Participant may not sell, assign, transfer or otherwise dispose of shares of Common Stock issued pursuant to Options granted under the Plan, unless (a) there is in effect with respect to such shares a registration statement under the Securities Act and any applicable state or foreign securities laws or an exemption from such registration under the Securities Act and applicable state or foreign securities laws, and (b) there has been obtained any other consent, approval or permit from any other regulatory body that the Committee, in its sole discretion, deems necessary or advisable. The Company may condition such issuance, sale or transfer upon the receipt of any representations or agreements from the parties involved, and the placement of any legends on certificates representing shares of Common Stock, as may be deemed necessary or advisable by the Company in order to comply with such securities law or other restrictions.

13. AMENDMENT OR TERMINATION.

The Board may suspend or terminate the Plan or any portion thereof at any time, and may amend the Plan from time to time in such respects as the Board may deem advisable in order that Options under the Plan will conform to any change in applicable laws or regulations or in any other respect the Board may deem to be in the best interests of the Company; provided, however, that no amendments to the Plan will be effective without approval of the shareholders of the Company if shareholder approval of the amendment is then required pursuant to Section 423 of the Code or the rules of any stock exchange or Nasdaq or similar regulatory body. Upon termination of the Plan, the Committee, in its sole discretion, may take any of the actions described in Section 9.3 of the Plan.

14. EFFECTIVE DATE OF PLAN.

The Plan will be effective as of June 10, 1999, the date it was adopted by the Board. The Plan will terminate at midnight on December 31, 2020 and may be terminated prior to such time by Board action, and no Option will be granted after such termination. The Plan has been adopted by the Board subject to shareholder approval.

15. MISCELLANEOUS.

15.1 GOVERNING LAW. The validity, construction, interpretation, administration and effect of the Plan and any rules, regulations and actions relating to the Plan will be governed by and construed exclusively in accordance with the laws of the State of Minnesota, notwithstanding the conflicts of laws principles of any jurisdictions.

15.2 SUCCESSORS AND ASSIGNS. The Plan will be binding upon and inure to the benefit of the successors and permitted assigns of the Company and the Participants.

15.3 WITHHOLDING. Delivery of shares of Common Stock or of cash pursuant to the Plan shall be subject to any required withholding taxes. A person entitled to receive shares of Common Stock may, as a condition precedent to receiving such shares, be required to pay the Company a cash amount equal to the amount of any required withholdings.

SELECT COMFORT CORPORATION
EXECUTIVE AND KEY EMPLOYEE INCENTIVE PLAN

1. PURPOSES. The purposes of this Executive and Key Employee Incentive Plan (the "Plan") are to: (a) enable Select Comfort Corporation and its affiliated entities, including majority owned subsidiaries (collectively, the "Company"), to attract and retain high caliber executives and key employees; (b) provide incentive compensation for such executives and key employees that is linked to the growth and profitability of the Company and increases in shareholder value; and (c) further the identity of interests of such executives and key employees with the interests of the Company's shareholders.

2. DETERMINATION OF ELIGIBILITY AND AWARDS.

(a) ELIGIBILITY, PERFORMANCE GOALS AND TARGET AWARDS. At the beginning of each fiscal year of the Company (each such fiscal year is referred to as a "Plan Period") and before the end of the first quarter of each Plan Period, the Compensation Committee of the Board of Directors (the "Committee") will determine:

(i) The employees of the Company, by grade level or otherwise, that are eligible to participate in the Plan for the Plan Period.

(ii) Quarterly and/or annual specific measures and goals from among consolidated sales growth and volume, net operating profit before tax, cash flow, earnings per share, return on capital, and/or return on assets, as the objective company performance goal or goals for the Plan Period. A single company performance goal or multiple company performance goals may be selected.

(iii) For each level of participant, (A) the target award, as a percentage of base compensation, that the participant will be eligible to receive, (B) the portion of the target award that will be based on achievement of the objective company performance goals, and (C) the portion of the target award, if any, that will be based on achievement of objective individual performance goals. Notwithstanding the foregoing, for the senior executive officers of the Company, at least 75% of any award hereunder must be based on achievement of the objective company performance goals and not more than 25% of any award may be based on achievement of objective individual performance goals.

(b) LIMITATION ON AWARDS. The maximum award payable to any participant under the Plan for any Plan Period will not exceed either 200% of the participant's base salary or \$1,000,000.

(c) FORM OF AWARDS. Unless otherwise expressly provided by the Committee at the time of granting an award, incentive compensation awards under this Plan will be granted

in cash, less any applicable withholding taxes, separate from the participants' base pay and will not be added to the participants' base pay.

(d) GRANT OF AWARDS. Any grant of an award under this Plan will be made only in the sole discretion of the Committee. No person will have a right to an award under this Plan until the Committee has taken final action granting such award. Following the grant of awards, the participant will be informed by the Company of the award and that the award is subject to the applicable provisions of this Plan.

(e) PAYMENT OF AWARDS. Payment of awards will be made as soon as practicable following the period for which the award is payable, and in any event within 45 days after the end of the quarter for quarterly awards and event within 90 days after the end of the year for annual awards.

3. FURTHER REQUIREMENTS FOR ELIGIBILITY FOR AWARDS. In addition to any requirements for eligibility to participate in the Plan that may be established by the Committee pursuant to the terms of the Plan, the following eligibility requirements will apply to all participants:

(a) No award may be granted to a member of the Company's Board of Directors except for services performed as an employee of the Company.

(b) Except in the event of normal retirement, death, or disability, to be eligible for an award an employee must be employed by the Company as of the date awards are calculated and approved for payment by the Committee or by the senior management of the Company under this Plan.

4. GENERAL TERMS AND CONDITIONS.

(a) ADMINISTRATION OF THE PLAN. Except as otherwise specifically provided, the Committee will administer the Plan. The Board of Directors of the Company will appoint the Committee members, and the members thereof will be ineligible for awards under this Plan.

(b) AUTHORITY OF THE COMMITTEE. The Committee will have the full power and authority, in its sole discretion, to make all decisions necessary to administer the Plan, to interpret and enforce the terms and conditions of the Plan and to determine the amounts payable to participants under the Plan, including without limitation, the full power and authority to reduce or eliminate the amount payable to any participant with respect to any award hereunder as may be necessary or appropriate in the sole discretion of the Committee. All decisions of the Committee with respect to any aspect of the Plan, including without limitation the administration of the Plan, the interpretation or enforcement of any term or condition of the Plan or the determination of any amount payable to any participant under the Plan will be final, conclusive and binding for all purposes.

(c) AMENDMENTS AND EXPIRATION DATE. The Company, acting through the Board of Directors, reserves the right to amend or modify this Plan from time to time or to repeal the Plan entirely, or to direct the discontinuance of granting awards either temporarily or permanently; provided, however, that no amendment or modification of this Plan will operate to annul, without the consent of the beneficiary, an award already granted hereunder; provided, also, that no amendment or modification without approval of the shareholders will increase the maximum amount which may be awarded as hereinabove provided.

(d) NO CONTRACT OF EMPLOYMENT. Nothing contained in this Plan will be construed as a contract or guaranty with or to any eligible employee of continued employment with Select Comfort Corporation or any of its subsidiary corporations for any period of time, at any grade level or at any rate of compensation. All eligible employees are employees "at will," whose employment is subject to termination at any time with or without cause. Nothing in this Plan will interfere with or limit in any way the right of Select Comfort Corporation or any subsidiary to terminate the employment or service of any eligible employee at any time, nor confer upon any eligible employee any right to continue in the employ or service of Select Comfort Corporation or any subsidiary.

(e) WITHHOLDING. Select Comfort Corporation is entitled to withhold and deduct from any payment made hereunder to any participant all legally required amounts necessary to satisfy any and all foreign, federal, state and local withholding and employment-related tax requirements attributable to any bonus payment made.

(f) GOVERNING LAW. The validity, construction, interpretation, administration and effect of the Plan and any rules, regulations and actions relating to the Plan will be governed by and construed exclusively in accordance with the laws of the State of Minnesota, notwithstanding the conflicts of laws principles of any jurisdiction.

July 11, 2000

Mr. Michael Thyken
8859 Flesher Circle
Eden Prairie, Minnesota 55347

Dear Mike:

It is with great pleasure that I confirm the terms of your employment with Select Comfort Corporation:

Effective as of July 12, 2000, you will be joining Select Comfort as Vice President and Chief Information Officer. Your annual salary will be \$150,000. You will also be granted stock options to purchase up to 40,000 shares of our common stock, vesting monthly over 36 months of employment. The exercise price of the stock options will be the average of the high and low trading prices on July 12, 2000. In addition, you will be eligible to participate in the company's management incentive plan. The terms of the management incentive plan for 2000 have not been finalized as of this date, but we currently anticipate that VP level executives will have a target bonus of approximately 35% of base compensation paid during the year.

You will be eligible for the following company benefits the first of the month following thirty days of employment: medical, dental, flex account, life and AD&D insurance, supplemental life and AD&D insurance, long-term disability, and travel accident insurance. You will be eligible to participate in the Company's 401(k) plan the first of the month following your start date, and in Employee Stock Purchase Plan (ESPP) the first offering period following your start date. You will be eligible for product discounts under the Employee Purchase Plan thirty (30) days from your start date. You will be covered under the Company's short-term disability plan after six (6) months of employment. You will be eligible for Select Comfort's Education Assistance Program after you have completed one year of full-time employment. We have enclosed further information regarding our benefits package for your review, and these benefits can be explained in greater detail during your new hire orientation.

You will accrue Paid Time Off (PTO) at a rate of 3.69 hours per week per calendar year. We will make an exception to our standard PTO accrual policy to accommodate your planned vacation during the week of July 24, 2000. Additionally, you will be eligible for company holidays.

Your employment is conditioned upon your signing our standard form of Employee Inventions, Confidentiality and Non-Compete Agreement, a copy of which is enclosed. Please let me know if you have any questions regarding that agreement.

You should understand that this letter does not constitute a contract of employment, nor is it to be construed as a guarantee of continuing employment for any period of time. Employment with Select Comfort is "at will".

We recognize your right to terminate the employment relationship at anytime and for any reason and, similarly, we reserve the right to alter, modify or terminate the relationship at any time and for any reason.

Mike, we are very excited about your joining our management team. Select Comfort is on the brink of an exciting and challenging era, and I feel with your background and skills you will be able to provide a significant contribution to our company and its success.

Please contact me at (952) 918-3020 with any questions or comments.

Sincerely,

/s/ Mark A. Kimball

Mark A. Kimball
Senior Vice President

October 27, 2000

Noel F. Schenker
1908 west 49th Street
Minneapolis, MN 55409

Dear Noel:

It is with great pleasure that I extend to you the following offer to join Select Comfort Corporation as Senior Vice President, Marketing and New Business Development, effective November 1, 2000:

Your annual salary will be \$250,000. In addition, under the terms of the Company's 2000 Management Incentive Plan, you are eligible to receive a bonus of 45% of the base salary actually paid to you for the year 2000, and this amount will be guaranteed to you for 2000. The terms of the Management Incentive Plan for 2001 are currently under development.

You will also be granted stock options to purchase up to 100,000 shares of our common stock. Of these options, 75,000 will vest in equal monthly increments over 36 months of employment, and 25,000 will vest upon the earlier of completion of 5 years of employment or such time as the stock price has exceeded \$12 per share for 30 consecutive trading days. The exercise price of the stock options will be the average of the high and low trading prices of the Company's common stock on the date of grant of the options, which will be on or near your first day of employment.

If your employment is terminated by the Company within one (1) year following a change in control of the Company, or if you are subject at any time to a termination without cause, or to a constructive dismissal due to significant diminution in your responsibilities, upon the termination of your employment under such circumstances, and subject to the execution and delivery to the Company of a standard release of claims, you will be entitled to receive one (1) year's base salary as severance compensation, and the portion of the stock options referred to above which have not previously been vested, will vest immediately and remain exercisable for a period not to exceed ninety (90) days following termination of employment. The severance compensation described above will be payable over a period of one (1) year following termination of employment in accordance with the Company's normal payroll schedule.

You will be eligible for the following company benefits as of the first of the month following 30 days of employment: medical, dental, flex account, life and AD&D insurance, supplemental life and AD&D insurance, long-term disability, travel accident insurance and Non-Qualified Deferred

Compensation Plan. You will be eligible to participate in the Company's 401(k) plan as of the first of the month following your start date, and in the Company's Employee Stock Purchase Plan (ESPP) as of the first quarterly offering period commencing after your start date. You will be eligible for product discounts under the Company's Employee Purchase Plan 30 days from your start date. You will be covered under the Company's short-term disability plan after six months of employment. You will be eligible for Select Comfort's Education Assistance Program after you have completed one year of full-time employment. We have previously forwarded to you detailed information regarding our benefits package for your review, and these benefits can be explained in greater detail during your new hire orientation.

You will accrue Paid Time Off (PTO) at a rate of 3.69 hours per week per calendar year up to a maximum of 24 days per year. Additionally, you will be given time off for Company holidays. You will also be eligible to participate in possible further future incentive programs and awards commensurate with your senior management position.

Your employment is conditioned upon your signing our standard form of Employee Inventions, Confidentiality and Non-Compete Agreement, a copy of which was previously forwarded to you for your review.

You should understand that this letter does not constitute a contract of employment, nor is it to be construed as a guarantee of continuing employment for any period of time. Employment with Select Comfort is "at will." We recognize your right to terminate the employment relationship at any time and for any reason and, similarly, we reserve the right to alter, modify or terminate the relationship at any time and for any reason.

We are very excited about your joining our management team. Select Comfort is on the brink of an exciting and challenging era, and I feel with your background and skills you will be able to provide a significant contribution to our company and its success.

Please contact me at (952) 918-3010 with any questions you may have.

Sincerely,

/s/ William R. McLaughlin

William R. McLaughlin
President & CEO

As of July 1, 2000

Select Comfort Retail Corporation
10400 Viking Drive
Suite 400
Minneapolis, Minnesota 55344

Attention: Mr. William McLaughlin
Chief Executive Officer

Dear Bill:

This will set forth the terms and conditions on which Select Comfort Retail Corporation ("you" or "your") agree to employ Messner Vetere Berger McNamee Schmetterer/EURO RSCG Inc. ("we" or "us") and we agree to serve, as your advertising agency in the United States.

I. BASIC SERVICES

Our services to you shall include services customarily performed by a general advertising agency. Specifically, we shall do the following:

(a) Formulate and submit for your approval advertising campaigns and recommendations.

(b) After approval by you, create and prepare advertising for consumer and trade print, broadcast and outdoor media.

(c) Develop a media strategy and plan for an agreed upon number of test markets (the "Test Markets") and support the proposed media plan with advertising strategy and rationales.

(d) Purchase all materials and services necessary for the production of finished advertisements and commercials.

(e) Execute advertising in finished form.

(f) Forward advertising material to media with proper instructions; it being understood and agreed that you will be responsible for all media placement and payment with respect to such advertising material and that for purposes of our forwarding such material to such media and of

1

our administering and monitoring any ongoing obligations, including talent and other payments, you shall provide to us (or confirm that we have) a full and accurate media schedule a reasonable time prior to the date that any such material must be forwarded to the applicable media.

(g) Pay all charges incurred and assumed by us on your behalf in accordance with the terms of this agreement.

(h) Endeavor to do all of the above on the most advantageous rates, terms and conditions available.

(i) Develop and provide you with rough concepts for certain significant collateral materials (such as sales promotion materials, brochures and store signage).

II. MINIMUM GUARANTEED COMPENSATION

Our compensation for advertising services set forth in Section I above will be a minimum annual fee of \$2,500,000, which you agree to pay in equal monthly installments of \$208,333, on the first of each month commencing July 1, 2000. (For purposes of clarity, the compensation set forth in this Section II does not cover any of the services set forth in Section VI below, including without limitation, media buying and checking services, and if you should desire us to perform any of the services set forth in Section VI below, including, without limitation, media buying and checking services, our compensation for such services shall be negotiated and agreed upon at the time of each such request.) If this agreement terminates on a date other than the first of a month, a prorated share of the minimum fee will be due for the final month.

III. MEDIA, PRODUCTION AND OTHER CHARGES

(a) You also agree to pay us for all third party charges incurred on your behalf for the production and purchase of advertising materials and programs, including, without limitation, typography, engraving, printing, photographs, artwork, comprehensive layouts, pasteups, mechanicals, photoboards, research, film, video tapes, editing, musical compositions and arrangements, radio and television programs and facilities, talent, props, scenery, sound and lighting effects, rights, royalties, producers' or packagers' fees, at our net cost.

(b) You also agree to pay us in accordance with our standard charges, which may be adjusted from time to time, for any studio functions performed by us including, without limitation, for any paste-ups, mechanicals, comprehensive production storyboards and photoboards, printing, typography, retouching, illustration, graphics, animation, designs (including computer aided design), digital image research, portable media, and color output and prints prepared or produced by our personnel.

(c) You agree to reimburse us for travel expenses, including transportation, hotels, meals, etc., of our personnel in connection with the servicing of your advertising account and any special services; charges originating with us for costs of forwarding, storing, shipping and mailing, telephoning, telegraphing, telecopier, facsimile transmissions, duplicating, courier and messenger services incurred in the servicing of your account; charges for talent payment services; and charges for legal services authorized by you, including without limitation, legal

review of advertising and other materials, trademark and copyright advice and registrations, negotiation of talent and other extraordinary contracts, and representation before industry and governmental regulatory agencies.

IV. INCENTIVE COMPENSATION

In the event that we continue to provide advertising services to you after June 30, 2001 (i.e., beyond the end of the first contract year), you and we agree that we shall be eligible to receive from you incentive compensation for the second contract year and for each contract year thereafter. The amount and manner of calculation of such incentive compensation shall be negotiated by you and us in good faith prior to the commencement of the second contract year and each contract year thereafter.

V. PAYMENTS

(a) We will bill you for charges in connection with our services upon your approval of estimates for such charges, and you agree to pay these charges within thirty (30) days, except that any payments we must make on your behalf must be collected from you no later than the earliest dates on which we must make payment on your behalf. In the event that we do not receive payments by the date set forth above, we shall have the right to not purchase or contract on your behalf or to cancel any contracts previously entered into on your behalf, and, in the event that we cancel any such contracts, you shall be responsible for any charges, commissions and fees incurred prior to, or as a result of, such cancellation. Billing adjustments will be made for differences between estimated charges previously billed and charges actually incurred upon completion of each job or project. If any payment is not received on a timely basis we will have the right to assess a finance charge of up to one and one-half percent (1 1/2%) per month on the unpaid balance.

VI. SPECIAL SERVICES

In addition to the basic services, we are prepared to render special services to you in support of traditional media advertising. Any special services agreed upon will be rendered in accordance with any special terms agreed upon in writing and charged to you in accordance with estimates which we will supply you. Special services will not be credited against any minimum fees. Special services include, without limitation, the following:

(a) Direct Response advertising and sales promotion material such as point-of-sale materials, direct mail, leaflets, inserts, catalogs, brochures, sales films, training films, sales manuals, and other material prepared for use other than in traditional advertising media; provided, however, that the development of rough concepts for significant collateral materials shall be included in Basic Services, in accordance with Paragraph I(i) hereof.

(b) Research services, other than copy development, such as studies of your products or services, studies of consumer or trade attitudes and behavior.

(c) Design services including packaging, trademarks and corporate identity programs.

(d) Special marketing services such as investigations of market potential and distribution problems.

(e) Services relating to the testing of new product concepts from pre-testing activities through active test marketing of new products.

(f) Staging or conducting sales or other company meetings and designing and preparing exhibits for trade or industry shows.

(g) Services related to promotions and events, including, without limitation, conducting and administering promotions and planning events.

(h) Designing, creating and producing interactive and on-line materials, Web sites and Web advertising, and serving and maintaining Web sites and Web advertising.

(i) Media buying and media checking services; provided, however, that if our advertising campaign performs well in the Test Markets and you roll such campaign out to additional markets, you and we will negotiate in good faith with respect to our providing media buying services in connection with such roll out (and thereafter) as well as the amount of the fee (or other compensation arrangement) payable by you to us in connection with such media buying services.

VII. GENERAL

(a) We will obtain your written authorization before making any substantial expenditures on your behalf. We are authorized to act on your behalf as an agent for a disclosed principal in connection with our services hereunder provided that such services are in connection with a job or project which has been (or such services have otherwise been) authorized by you.

(b) If you should desire any advertising material or special material created by us (or anything derived from such material) to be placed outside the United States, you and we will agree upon the terms in advance.

(c) As between you and us, any plan, advertising material or special material which we produce on your behalf will become your property when you have paid our invoices. Any material or ideas prepared or submitted to you, which you have chosen not to produce or for which you have not paid our corresponding production invoices, will remain our property (regardless of whether the physical embodiment of creative work is in your possession in the form of copy, artwork, plates, recordings, films, tapes, etc.) and may be submitted to other clients for their use, provided that such submission or use does not involve the release of any confidential information regarding your business or methods of operation. For purposes hereof, "produce" shall be defined as any material which is created in tangible form pursuant to a signed production estimate.

(d) We hereby agree to indemnify and hold you harmless from and against any and all claims, demands, regulatory proceedings and all damages, costs (including, without limitation, settlement costs) and expenses (including, without limitation, reasonable attorneys' fees) arising from any claim pertaining to libel, slander, defamation, copyright infringement, invasion of

privacy, piracy and/or plagiarism arising from your use consistent with releases and agreements with third parties of any materials we create or supply to you, except to the extent that such claims arises from materials created or supplied by you.

(e) Other than that for which we agree to indemnify and hold you harmless pursuant to Section VII(d) above, you hereby agree to indemnify and hold us harmless from and against any and all claims, demands, regulatory proceedings and all damages, costs (including, without limitation, settlement costs) and expenses (including, without limitation, reasonable attorneys' fees) arising from or relating to any activities undertaken by us on your behalf, the use by you, your retailers or dealers, or anyone else of any materials we create or supply to you, or your products or services.

(f) We will use our reasonable best efforts to guard against any loss to you caused by the failure of media, suppliers or others to perform in accordance with their commitments, but we will not be responsible for any such loss or failure on their part, or any destruction or unauthorized use by others of your property.

(g) You have the right at any time to direct us to cancel any plans, schedules or work in progress, but you agree to indemnify us against any loss, cost or liability we may sustain as a result of such action. We will be entitled to our commissions, fees and payments for services performed prior to your instructions to cancel, and for advertising and materials placed or delivered thereafter if we are unable to halt such placement or delivery. Under no circumstances will we be obliged to breach any lawful contractual commitment to others.

(h) In the event that we are required to resort to collection procedures or litigation for the collection of any compensation due us, we shall be entitled to collect from you reasonable attorneys' fees and costs in addition to such compensation.

(i) At reasonable times and on reasonable notice to us, you may examine our files and records which pertain specifically to your advertising.

VIII. TERMINATION

(a) We shall continue to serve as your advertising agency until you or we shall terminate our services with or without cause, or with respect to specified products or services assigned to us by giving not less than ninety days' prior written notice by registered mail to the principal place of business of the other. However, you agree not to give notice of termination prior to April 1, 2001. Notice of termination shall become effective upon receipt of such notice by the party to whom it is addressed.

(b) Our rights and duties hereunder shall continue in full force during the ninety day notice period, but our responsibilities shall be limited to supervising and administering then existing advertising campaigns.

(c) Any reservation, contract or arrangement made by us for you prior to the termination date which continues beyond the termination date will be carried to completion by us and paid for by you in accordance with this agreement unless you direct us to transfer such reservation, contract or arrangement to another entity and you release and indemnify us, in which event we will attempt to make such transfer, subject to obtaining any necessary consent of third parties. We will be entitled to our commissions, fees and payments for services performed prior to accomplishing the transfer. Upon termination, provided that you have no outstanding indebtedness to us and you assume any third party obligations (including, without limitation, any applicable union or guild obligations relating to the production and use of commercials), we shall transfer in accordance with your instructions all property and materials owned by you which are under our control.

(d) All indemnification obligations shall survive the termination of our services or the termination or expiration of this agreement.

IX. MISCELLANEOUS

(a) This agreement contains the entire understanding between the parties and may not be altered or waived except by a writing signed by both parties. No waiver by either party of the breach of any term or condition of this agreement will constitute a waiver of, or consent to, any subsequent breach of the same or any other term or condition of this agreement.

(b) This agreement will be governed by the law of the State of New York to contracts executed and to be performed entirely in the State of New York.

Please indicate your acceptance of the terms and conditions by signing the enclosed copy of this letter and returning it to us.

Very truly yours,

MESSNER VETERE BERGER MCNAMEE
SCHMETTERER/EURO
RSCG INC.

By: /s/Larry Dexheimer

Authorized Officer

AGREED TO:

SELECT COMFORT RETAIL CORPORATION

By: /s/William R. McLaughlin

Authorized Officer

INDEPENDENT AUDITORS' CONSENT

The Board of Directors
Select Comfort Corporation:

We consent to incorporation by reference in the registration statements on Form S-8 (No. 333-70493, No. 333-79157, No. 333-80755, and No. 333-84329) of Select Comfort Corporation, of our reports dated February 2, 2001, except as to Notes 1 and 10 which are as of April 12, 2001, relating to the consolidated balance sheets of Select Comfort Corporation and subsidiaries, as of December 30, 2000, and January 1, 2000, and the related consolidated statements of operations, shareholders' equity and cash flows and the related financial statement schedule for each of the fiscal years in the three-year period ended December 30, 2000, which reports appear in the Annual Report on Form 10-K of Select Comfort Corporation for the fiscal year ended December 30, 2000.

Our report dated February 2, 2001, except as to Notes 1 and 10 which are as of April 12, 2001, contains an explanatory paragraph that states that the Company has negative cash flows that raises substantial doubt about its ability to continue as a going concern. The consolidated financial statements and financial statement schedule do not include any adjustments that might result from the outcome of this uncertainty.

/s/ KPMG LLP

Minneapolis, Minnesota
April 16, 2001

1,000

12-MOS
DEC-30-2000
JAN-02-2000
DEC-30-2000

		1,498
	3,950	
	2,957	
	264	
	11,083	
	23,965	
		60,903
	23,840	
	64,672	
42,141		
		0
0		
		0
		180
	16,420	
64,672		
		270,077
	270,077	
		98,924
	98,924	
	0	
	466	
	26	
	(25,622)	
	11,592	
(37,214)		
	0	
	0	
		0
	(37,214)	
	(2.09)	
	(2.09)	