Foster School of Business

Apple Inc. (B)

"The iPhone Revenue Bomb"*

"Some Apple watchers have complained almost since the launch of the iPhone that Wall Street doesn't understand the device's value to the company. Analysts consistently underestimate Apple's revenue, these investors insist, because they fail to fully account for iPhone sales."
Phillip Elmer-DeWitt. Source: tech.fortune.com, October 23, 2008

Apple's success continued unabated in fiscal 2008 and 2009 partially fueled by growing unit sales of the iPhone (Exhibit 1). Still, Apple management was dissatisfied with subscription accounting for the iPhone that translated unit sales into dollar sales. CEO Steve Jobs felt the accounting understated the importance of the iPhone and confused both investors and Apple managers.

> Because by its nature subscription accounting spreads the impact of iPhone's contribution to Apple's overall sales, gross margin, and net income over two years, it can make it more difficult for the average Apple manager or the average investor to evaluate the company's overall performance. As long as our iPhone business was small relative to our Mac and music businesses, this didn't really matter much. But this past quarter, … our iPhone business has grown to about $4.6 billion, or 39% of Apple's total business, clearly too big for Apple management or investors to ignore. Hence our introduction today of non-GAAP financial results alongside our reported GAAP results. Steve Jobs, Apple CEO, October 21, 2008.

"At the heart of the problem for Apple is its decision to offer iPhone owners free software updates from time to time -- a practice that required its accountants to spread the revenue from iPhone sales over the life of a cellphone contract, typically two years."[1]

Recognizing revenue for sales of products with multiple deliverables

Then-existing revenue recognition rules for products with multiple elements or 'deliverables' (such as an iPhone that was bundled with software *and* the promise of free future software upgrades) relied on 'vendor-specific objective evidence' (VSOE) of the fair value of each deliverable.[2] If any deliverable in the bundle did not have VSOE, revenue had to be deferred for all elements of the bundle. Many technology companies argued that it was difficult, if not impossible, to measure the fair value of a deliverable that was an integral part of the product and not sold separately, such as the operating system software for the iPhone. Further, the

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* Prepared by Professor Robert Bowen and Jane Jollineau Kennedy for class discussion purposes only. The comments of Frank Hodge are appreciated. Revised, October 10, 2010.

[1] Source: http://tech.fortune.cnn.com/2009/09/14/accounting-rule-change-in-apples-favor/#more-11374

[2] VSOE is equivalent to the price charged by the vendor when a deliverable is sold separately – or if not sold separately, the price established by management for a separate transaction that is not likely to change. Third-party evidence of fair value, such as prices charged by competitors, is acceptable if vendor-specific evidence is unavailable. Source: http://www.cfo.com/article.cfm/14440468

promise of free upgrades led to uncertainty in the value, number and timing of these undelivered deliverables. Because of these uncertainties, Apple management elected to defer essentially all revenue related to the iPhone and recognize it ratably over the iPhone's life, estimated to be two years. As a result, Apple's deferred revenue grew dramatically from $2.2 billion at yearend fiscal 2007 to $14.8 billion at yearend fiscal 2009 (Exhibit 2).

Fourth quarter 2008 conference call: "The day Apple released its iPhone revenue bomb"[3]

On Tuesday, October 21, 2008, Apple CFO Peter Oppenheimer announced at the fiscal 2008 fourth quarter conference call that Apple would provide non-GAAP estimates of revenue, gross margin and earnings *as if* the Company recognized iPhone and Apple TV revenue at the point-of-sale. In other words, the non-GAAP numbers would put iPhone and Apple TV sales on the same basis as the company used for its other products, including Macintosh computers and iPods. Oppenheimer went on to discuss three implications of the new non-GAAP numbers.

> I would now like to go through several of the non-GAAP measures. First, we use a non-GAAP measure that we call adjusted sales to provide more information regarding our underlying sales trends and to evaluate the sales dollars of products sold in the period. We calculated adjusted sales by backing out the September quarter's amortization of deferred revenue from iPhone and Apple TV sales and adding back all amounts generally due at the time of sale for iPhones and Apple TVs shipped in the September quarter.
>
> Adjusted sales totaled $11.7 billion, which was about $3.8 billion higher than our reported revenue of $7.9 billion.
>
> Second, we use a non-GAAP measure we call adjusted cost of sales that corresponds to adjusted sales. We calculated adjusted cost of sales by backing out the September quarter's amortization of deferred costs related to iPhone and Apple TV and adding back the total cost of the iPhones and Apple TVs shipped in the September quarter. We also used an estimate of the total future warranty expense related to the iPhones and Apple TVs sold in the September quarter rather than reflecting the actual iPhone and Apple TV warranty expenses incurred during the September quarter. We then calculated the non-GAAP measure of adjusted gross margin by subtracting adjusted cost of sales from adjusted sales. For the September quarter, adjusted gross margin was $4.6 billion, which was $1.8 billion higher than recorded gross margin.
>
> Third, we used the non-GAAP measure of adjusted net income to evaluate our performance based on the current period iPhone and Apple TV sales and to facilitate ongoing operating decisions. For the September quarter, adjusted net income was $2.4 billion, which was $1.3 billion higher than reported net income.

Next, Oppenheimer introduced CEO Steve Jobs who made his first appearance at a Company conference call in eight years. Jobs drove home the message about the limitations of Apple's subscription accounting in reporting the success of the iPhone.

> Hi, everyone. Some remarkable things are happening at Apple but everything is now set against the backdrop of this global economic slowdown, so it seemed like a good time for me to make a few remarks and help answer some of your questions.
>
> I would like to go back and talk about the non-GAAP financial results because I think this is a pretty

[3] Source: http://tech.fortune.cnn.com/2008/10/23/the-day-apple-released-its-iphone-revenue-bomb/

> big deal. In addition to reporting an outstanding quarter, today we are also introducing non-GAAP financial results, which eliminate the impact of subscription accounting. As you know, subscription accounting is the solution we adopted to let us provide free software updates to iPhone users under GAAP accounting rules. In accordance with the subscription accounting treatment required by GAAP, Apple recognizes the revenue and the cost of goods sold for the iPhone over its economic life of two years rather than upon sale as we do for Macs and iPods.
>
> As you can see, the non-GAAP financial results are truly stunning. By eliminating subscription accounting, adjusted sales for the quarter were $11.68 billion, 48% higher than the reported revenue of $7.9 billion, while adjusted income was $2.44 billion, 115% higher than the reported net income of $1.14 billion. Adjusted net income that is more than double our reported income -- if this isn't stunning, I don't know what is, all due to the incredible success of the iPhone 3G.

Exhibit 3 provides Apple's reconciliation between the official GAAP numbers and the new non-GAAP numbers. Apple continued to provide non-GAAP revenue, gross margin and net income numbers through fiscal 2009.

Lobbying to change the rules

Apple and other technology companies lobbied the Financial Accounting Standards Board (FASB) to change the revenue recognition rules. (The FASB operates under the auspices of the SEC and sets accounting standards in the United States.) In all, 34 companies, including Dell, Hewlett-Packard, IBM, Palm, Tivo and Xerox, wrote to the FASB during a month-long comment period that ended in August 2009.[4] These companies overwhelmingly stated their opposition to the current revenue recognition standards in the presence of multiple deliverables including hardware, software, professional services, maintenance, and support.

Apple's position was articulated in an 8-page letter from Controller Betsy Rafael to the FASB. A short excerpt captures Rafael's key argument.

> "[The current rule] often results in accounting that does not reflect the underlying economics of transactions and can result in financial reporting that lacks the transparency necessary to fully inform users making investment decisions." Betsy Rafael, Apple Vice President and Corporate Controller and Principal Accounting Officer, in a letter to the FASB's Emerging Issues Task Force, August 13, 2009.

Accounting policymakers respond

On September 14, 2009, the FASB announced new draft revenue recognition rules that would allow Apple and other technology companies to report most revenue at the point-of-sale, even if some components would be delivered over the products life. The FASB unanimously approved the rule change on September 23, 2009, and it became mandatory for new revenue recognition arrangements entered into after June 15, 2010. Some believed that Apple would begin implementing the new rules in their first fiscal quarter of 2010, which began approximately two weeks later on October 1, 2009.

[4] Source: http://www.cfo.com/article.cfm/14440468

A summary of the updated FASB policy on revenue recognition follows:[5]

> The amendments in this Update establish a selling price hierarchy for determining the selling price of a deliverable. The selling price used for each deliverable will be based on vendor-specific objective evidence if available, third-party evidence if vendor-specific objective evidence is not available, or estimated selling price if neither vendor-specific objective evidence nor third-party evidence is available. The amendments in this Update also will replace the term *fair value* in the revenue allocation guidance with *selling price* to clarify that the allocation of revenue is based on entity-specific assumptions rather than assumptions of a marketplace participant.

It would appear that the new accounting principles would require Apple to account for the sale of the iPhone as two deliverables: (i) the hardware and software delivered at the time of sale and (ii) the right included with the purchase of iPhone and Apple TV to receive unspecified free software upgrades. The value of each deliverable would have to be estimated and revenue would be recognized as earned.

Mad Money's Cramer goes ape for Apple

On September 15, 2009, Jim Cramer, host of CNBC's Mad Money upped his target price for Apple shares from $200 to $264 based on the projected effect of the new revenue recognition rules on Apple's reported revenue and earnings. See Exhibit 4 for a summary. The show appeared to spark a rally on the following day that sent Apple shares up over 6% (almost 11 points) to a 15-month high of $186.79.

Fiscal 2009 results

Apple filed its fiscal 2009 10-K on October 27, 2009. Exhibits 5, 6 and 7 present financial statements from that filing. Net income growth appeared to have slowed, increasing only 18% from fiscal 2008 to 2009, compared to the 38% growth experienced from fiscal 2007 to 2008 (Exhibit 6). Worse yet, cash from operating activities increased less than 6% from fiscal 2008 to 2009, compared to the 75% growth experienced from fiscal 2007 to 2008 (Exhibit 7). Was Apple's recent success fading?

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[5] FASB Accounting Standards Update No. 2009-13, "Revenue Recognition (Topic 605) Multiple Deliverable Revenue Arrangements," October 2009.

Case Questions:

From an investor/analyst perspective:

1. To the best of your ability, estimate the annual non-GAAP 'adjusted' gross margin for fiscal 2009. [Hint: Using Exhibit 3 as a template (which is prepared for one fiscal quarter), reconcile fiscal 2009 net sales as reported versus non-GAAP net sales, cost of sales as reported versus non-GAAP cost of sales, and gross margin as reported versus non-GAAP gross margin. *Please ignore all line items below gross margin*.]

2. "Which numbers, 'as reported' or 'non-GAAP,' do you think better captures the underlying economics of selling an iPhone? What is your overall view of Apple's performance in fiscal 2009 versus fiscal 2008 and 2007?

3. Evaluate Jim Cramer's CNBC Mad Money coverage of Apple. What implicit or explicit assumptions does he make in his recommendation to buy Apple stock? Trying to avoid hindsight, do you agree with his statements? Why or why not? (See Blackboard for a link to the video.)

4. Evaluate Apple's short-term liquidity and financial leverage. [Hint: at a minimum, calculate Apple's current ratio and total-debt to equity ratio at fiscal yearend 2008 and 2009.]

From Apple Managements' perspective:

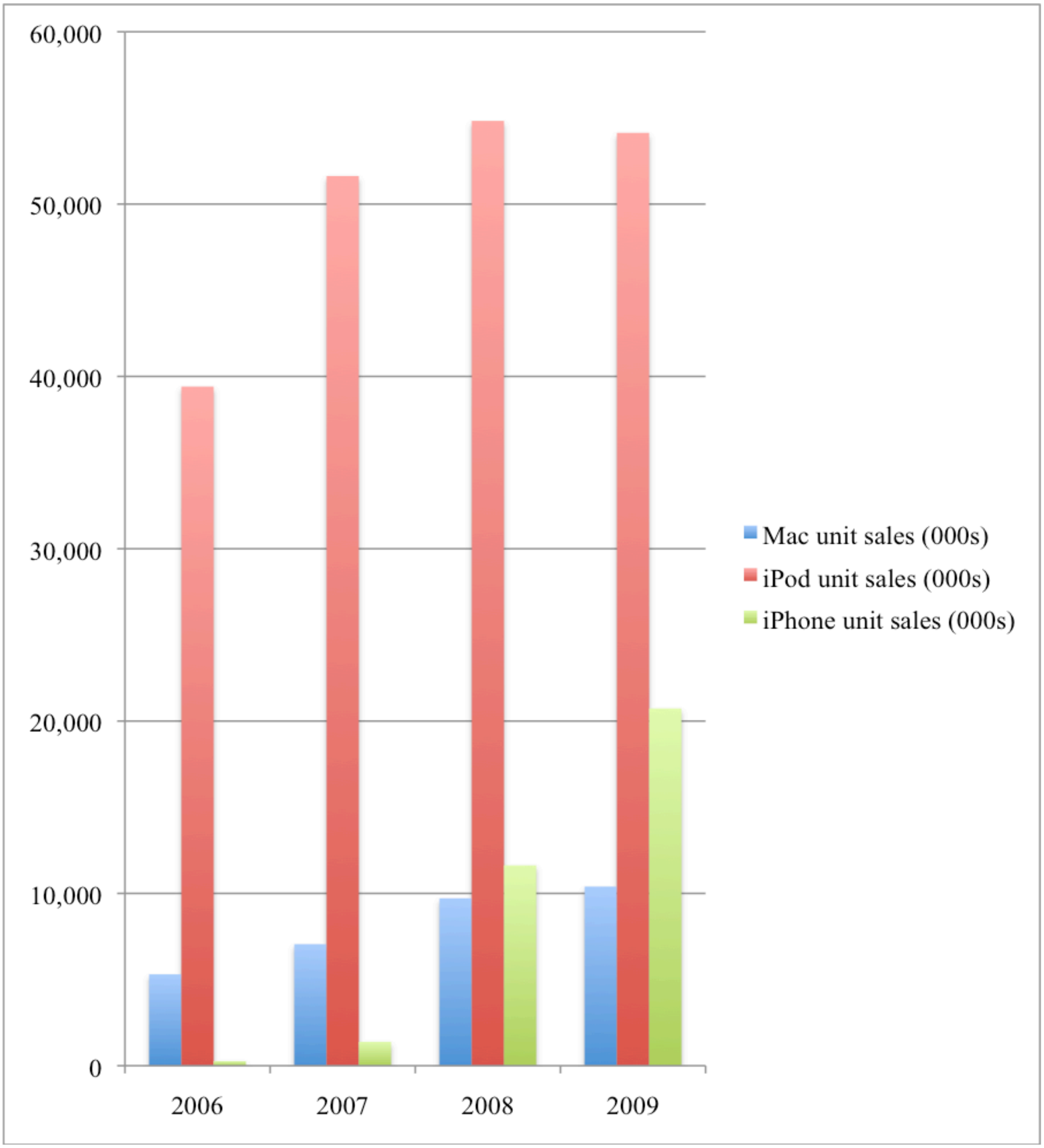
5. Speculate as to why Apple waited over a year after it launched the iPhone to report non-GAAP adjusted numbers?

6. In implementing the updated revenue recognition standards:
   a. what specific assumptions must Apple make about the deliverables associated with the iPhone?
   b. Without looking up subsequent Apple disclosures, how much revenue would you expect Apple to defer upon the sale of a $199 iPhone under the updated revenue recognition standards?
   c. How much revenue do you believe Apple should defer upon the sale of an iPhone in order to best capture the underlying economics of the transaction?

7. Apple had a choice to adopt the new revenue recognition standard retrospectively (or not); would you recommend retrospective adoption -- why?[6]

[6] To report "retrospectively" means that Apple would go back in time and restate its financial statements *as if* the Company had always used the new revenue recognition standards. The alternative was to only account for new sales using the updated standard.

Exhibit 1: Apple unit sales by product, fiscal 2006 - 2009



Source: Apple 10-Ks filed with the Securities and Exchange Commission.

Exhibit 2: Apple's deferred revenue balances

*Panel A: fiscal yearend 2007 and 2008**

UNADUITED CONSOLIDATED SCHEDULE OF DEFERRED REVENUE
(In millions)

	September 27, 2008	June 28, 2008	September 29, 2007
Deferred revenue-current:			
iPhone and Apple TV	$ 3,518	$ 1,389	$ 346
AppleCare	599	547	430
Other	736	791	615
Total deferred revenue-current	4,853	2,727	1,391
Deferred revenue-non-current:			
iPhone and Apple TV	2,262	632	290
AppleCare	651	597	495
Other	116	107	64
Total deferred revenue-non-current	3,029	1,336	849
Total deferred revenue	$ 7,882	$ 4,063	$ 2,240

*Panel B: fiscal yearend 2008 and 2009**

UNAUDITED CONSOLIDATED SCHEDULE OF DEFERRED REVENUE
(In millions)

	September 26, 2009	June 27, 2009	September 27, 2008
Deferred revenue - current:			
iPhone and Apple TV	$ 8,519	$ 6,767	$ 3,518
AppleCare	791	725	599
Other	995	977	736
Total deferred revenue - current	10,305	8,469	4,853
Deferred revenue - non-current:			
iPhone and Apple TV	3,618	2,860	2,262
AppleCare	688	653	651
Other	179	154	116
Total deferred revenue - non-current	4,485	3,667	3,029
Total deferred revenue	$ 14,790	$ 12,136	$ 7,882

* The first and third columns of numbers in each schedule above provide end of fiscal year data on deferred revenue. The middle column provides data on deferred revenue for the end of the third fiscal quarter.

Exhibit 3: Apple reconciliation of GAAP and Non-GAAP 'adjusted' numbers

UNAUDITED RECONCILIATION OF NON-GAAP TO GAAP RESULTS OF OPERATIONS
(In millions, except share amounts which are reflected in thousands and per share amounts)

	Three Months Ended September 27, 2008						
		As Reported		Non-GAAP Adjustments			Non-GAAP
Net sales	$	7,895	$	3,787	(a)	$	11,682
Cost of sales		5,156		1,975	(b)		7,131
Gross margin		2,739		1,812	(c)		4,551
Operating expenses		1,297		-			1,297
Operating income		1,442		1,812	(c)		3,254
Other income and expense		140		-			140
Income before provision for income taxes		1,582		1,812	(c)		3,394
Provision for income taxes		446		511	(d)		957
Net income	$	1,136	$	1,301	(e)	$	2,437
Earnings per diluted common share	$	1.26	$	1.43	(f)	$	2.69
Shares used in computing diluted earnings per share		904,786					904,786

Footnotes:

(a) Non-GAAP adjustments to net sales reflect (i) the reversal of current period's amortization of deferred revenue derived from iPhone handsets and Apple TV units shipped in current and prior periods and (ii) the inclusion of amounts generally due to Apple at the time of sale related to iPhone handsets and Apple TV units shipped in the current period.

(b) Non-GAAP adjustments to cost of sales reflect (i) the reversal of current period's amortization of deferred cost related to iPhone handsets and Apple TV units shipped in current and prior periods and (ii) the inclusion of the total cost of iPhone handsets and Apple TV units shipped in the current period. In addition, the non-GAAP adjustment to cost of sales reflects the estimate of the warranty expense in the period when the related product is sold, rather than when the expense is incurred. The non-GAAP adjustment to cost of sales does not reflect the cost of providing unspecified additional software products and upgrades.

(c) Non-GAAP adjustments to gross margin, operating income and income before provision for income taxes are the difference between non-GAAP adjustments to net sales and non-GAAP adjustments to cost of sales [(a) – (b)].

(d) Represents the application of the period's effective tax rate to the non-GAAP adjustments to income before the provision for income taxes.

(f) Represents the per share impact of the non-GAAP adjustments to net income.

Source: Apple press release, "Apple Reports Fourth Quarter Results," October 21, 2008.

Exhibit 4: Cramer of CNBC's "Mad Money" increases target price for Apple shares

On September 15, 2009, Jim Cramer, host of CNBC's Mad Money upped his target price for Apple shares from $200 to $264 based on the projected effect of the new revenue recognition rules on Apple's revenue and earnings. Cramer is holding up his new target price in the photo below.

Some excerpts roughly transcribed from the show:

"I have the most aggressive price target [for Apple] on Wall Street because I have the highest earnings estimates."

"I am letting you in on this first." "This is based on accounting." "It's how the big funds evaluate Apple's stock."

"There is about to be simple change in accounting rules that will send Apple's consensus earnings estimates from $8 per share to $12 per share, a 50% increase." "Investors will come to see Apple's stock as dirt cheap right here, which it really is."

"You've got to remember that the single most important determinant of a stock price is the future earnings of the company underneath it."

"My new price target: $12 per share x 22 multiple = $264."

"How is this possible? How could a company be so mis-valued? If I know about this accounting rule change, shouldn't all the pros know too? Take it from me, a hedge fund manager that did pretty well over many years, the markets aren't as efficient as you think."

Cramer goes on to trash existing subscription accounting for the iPhone… "What a dumb smart phone rule."

Some claim that Cramer's show sparked a rally on the following day that sent Apple shares up over 6% (almost 11 points) to a 15-month high of $186.79.[7]

[7] Source: http://tech.fortune.cnn.com/2009/09/16/apple-pops-on-mad-money-report/

Exhibit 5: Apple Balance Sheets

CONSOLIDATED BALANCE SHEETS
(In millions, except share amounts)

	September 26, 2009	September 27, 2008
ASSETS:		
Current assets:		
Cash and cash equivalents	$ 5,263	$11,875
Short-term marketable securities	18,201	10,236
Accounts receivable, less allowances of $52 and $47, respectively	3,361	2,422
Inventories	455	509
Deferred tax assets	2,101	1,447
Other current assets	6,884	5,822
Total current assets	36,265	32,311
Long-term marketable securities	10,528	2,379
Property, plant and equipment, net	2,954	2,455
Goodwill	206	207
Acquired intangible assets, net	247	285
Other assets	3,651	1,935
Total assets	$53,851	$39,572
LIABILITIES AND SHAREHOLDERS' EQUITY:		
Current liabilities:		
Accounts payable	$ 5,601	$ 5,520
Accrued expenses	3,376	3,719
Deferred revenue	10,305	4,853
Total current liabilities	19,282	14,092
Deferred revenue - non-current	4,485	3,029
Other non-current liabilities	2,252	1,421
Total liabilities	26,019	18,542
Commitments and contingencies		
Shareholders' equity:		
Common stock, no par value; 1,800,000,000 shares authorized; 899,805,500 and 888,325,973 shares issued and outstanding, respectively	8,210	7,177
Retained earnings	19,538	13,845
Accumulated other comprehensive income	84	8
Total shareholders' equity	27,832	21,030
Total liabilities and shareholders' equity	$53,851	$39,572

Source: fiscal year 2009 Apple 10-K filed with the Securities and Exchange Commission.

Exhibit 6: Apple Income Statements

CONSOLIDATED STATEMENTS OF OPERATIONS

(In millions, except share amounts which are reflected in thousands and per share amounts)

Three years ended September 26, 2009	2009	2008	2007
Net sales	$ 36,537	$ 32,479	$ 24,006
Cost of sales	23,397	21,334	15,852
Gross margin	13,140	11,145	8,154
Operating expenses:			
Research and development	1,333	1,109	782
Selling, general and administrative	4,149	3,761	2,963
Total operating expenses	5,482	4,870	3,745
Operating income	7,658	6,275	4,409
Other income and expense	326	620	599
Income before provision for income taxes	7,984	6,895	5,008
Provision for income taxes	2,280	2,061	1,512
Net income	$ 5,704	$ 4,834	$ 3,496

Source: fiscal year 2009 Apple 10-K filed with the Securities and Exchange Commission.

Exhibit 7: Apple Statements of Cash Flows

CONSOLIDATED STATEMENTS OF CASH FLOWS
(In millions)

Three years ended September 26, 2009	2009	2008	2007
Cash and cash equivalents, beginning of the year	$ 11,875	$ 9,352	$ 6,392
Operating Activities:			
Net income	5,704	4,834	3,496
Adjustments to reconcile net income to cash generated by operating activities:			
Depreciation, amortization and accretion	703	473	317
Stock-based compensation expense	710	516	242
Deferred income tax (benefit)/expense	(519)	(368)	78
Loss on disposition of property, plant and equipment	26	22	12
Changes in operating assets and liabilities:			
Accounts receivable, net	(939)	(785)	(385)
Inventories	54	(163)	(76)
Other current assets	(1,050)	(1,958)	(1,540)
Other assets	(1,346)	(492)	81
Accounts payable	92	596	1,494
Deferred revenue	6,908	5,642	1,139
Other liabilities	(184)	1,279	612
Cash generated by operating activities	10,159	9,596	5,470
Investing Activities:			
Purchases of marketable securities	(46,724)	(22,965)	(11,719)
Proceeds from maturities of marketable securities	19,790	11,804	6,483
Proceeds from sales of marketable securities	10,888	4,439	2,941
Purchases of other long-term investments	(101)	(38)	(17)
Payments made in connection with business acquisitions, net of cash acquired	—	(220)	—
Payment for acquisition of property, plant and equipment	(1,144)	(1,091)	(735)
Payment for acquisition of intangible assets	(69)	(108)	(251)
Other	(74)	(10)	49
Cash used in investing activities	(17,434)	(8,189)	(3,249)
Financing Activities:			
Proceeds from issuance of common stock	475	483	365
Excess tax benefits from stock-based compensation	270	757	377
Cash used to net share settle equity awards	(82)	(124)	(3)
Cash generated by financing activities	663	1,116	739
(Decrease)/increase in cash and cash equivalents	(6,612)	2,523	2,960
Cash and cash equivalents, end of the year	$ 5,263	$ 11,875	$ 9,352
Supplemental cash flow disclosures:			
Cash paid for income taxes, net	$ 2,997	$ 1,267	$ 863

Source: fiscal year 2009 Apple 10-K filed with the Securities and Exchange Commission.

Exhibit 8: Excerpts from notes to the financial statements

Note 4 – Consolidated Financial Statement Details

Other Current Assets

	2009	2008
Deferred costs under subscription accounting - current	$ 3,703	$ 1,931
Vendor non-trade receivables	1,696	2,282
Inventory component prepayments - current	309	475
Other current assets	1,176	1,134
Total other current assets	$ 6,884	$ 5,822

Other Assets

	2009	2008
Deferred costs under subscription accounting - non-current	$1,468	$1,089
Inventory component prepayments - non-current	844	208
Deferred tax assets - non-current	259	138
Capitalized software development costs, net	106	67
Other assets	974	433
Total other assets	$3,651	$1,935

Source: fiscal year 2009 Apple 10-K filed with the Securities and Exchange Commission.