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Apple Inc. (A)

"iPhone Revenue Recognition Strategy"[*]

"GAAP does not tell companies how to run their business."
Gerard Carney, spokesman for the Financial Accounting Standards Board.
Source: CNET News.com, January 19, 2007

Apple Inc.'s CEO Steve Jobs announced the iPhone® at a media event in January 2007 (Exhibit 1). Jobs characterized the iPhone as more intelligent and easier to use than both traditional cell phones and current generation 'smart' phones (Exhibit 2). Jobs said the iPhone was Apple's third revolutionary product line, following the Macintosh introduced in January 1984 and the iPod launched in October 2001. In addition, he said the iPhone's patented 'multi-touch' interface represented Apple's third revolutionary user interface, joining the computer mouse used to control the Macintosh and the click-wheel used to operate the iPod.

Apple released the iPhone for sale in the U.S. at 6 pm on Friday, June 29, 2007 to unprecedented fanfare, long lines and largely rave reviews. Initial pricing of the iPhone was $499 for the 4 gigabyte model and $599 for the 8 gigabyte version.[1] Apple sold 270,000 iPhones during the first 30 hours making the iPhone the most successful new product release in Apple's history. A spokesman for Apple's partner, AT&T, said, "We've sold more iPhones in the first weekend than we've sold in the first *month* of any other wireless device in AT&T's history."[2]

Despite the impressive start, Apple's earnings for the fiscal third quarter ended June 30, 2007 were likely *hurt* by the iPhone introduction. The company disclosed in their fiscal third quarter conference call with analysts that *total* revenue from iPhone sales was only $5 million – an average of less than $19 per iPhone and an insignificant amount compared to the quarter's total net sales across all products and services of over $5.4 billion (Exhibit 3). During the question and answer portion of the call, the company disclosed that the "vast majority" of reported iPhone revenue was due to the sale of accessories – not the phones themselves. Further, the company had expensed other operating costs related to the iPhone including R&D, Sales and Marketing. These latter costs were unusually high before and during the launch period because of a large increase in advertising and extra staffing in customer support and in Apple's online and physical stores. There seemed little doubt that iPhone-related operating expenses amounted to far more than the $5 million of reported revenue. The seeming disconnect between the iPhone's widely touted launch success and its apparently poor initial financial performance was likely due to Apple's revenue recognition policy for the iPhone called 'subscription' accounting.

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[*] Prepared by Professor Robert Bowen for class discussion purposes only. The comments of Frank Hodge, Jane Kennedy, Dawn Matsumoto and Terry Shevlin are appreciated. Revised, October 2010.

[1] On September 5, 2007 Apple introduced a Wi-Fi capable touch-screen iPod called the iPod Touch. The Touch was very similar to an iPhone without the phone features. At the same time the Company eliminated the 4 gigabyte version of the iPhone from the product line and lowered the price of the 8 gigabyte iPhone to $399.

[2] Source: "AT&T says iPhone activation problems largely solved" Reuters, July 3, 2007.

Revenue Recognition at Apple

Apple listed 'revenue recognition' among its critical accounting policies and estimates. Like the overwhelming majority of businesses, Apple had consistently used 'point-of-sale' revenue recognition for hardware sales including the Macintosh and the iPod. That is, 100% of the selling price was recognized as revenue when a product was shipped to a customer.[3] Most customers purchased directly from Apple via its on-line store or one of more than 170 physical Apple Stores. The remaining customers purchased Apple products from resellers such as Amazon.com and Best Buy.

Revenue Recognition and the "N" generation wireless upgrade

In January 2007, Apple announced it had built-in next-generation wireless "N" capability in selected Macintosh notebook and desktop computers that it had been selling since the prior September. However, in order to activate this new built-in "N" standard, Apple required customers to pay $1.99 for software to turn on the feature.

This previously unannounced upgrade fee created heated discussion on the Internet. Most bloggers and forum participants were negative about charging for something already inside the computer. Apple blamed the nominal charge on accounting standards, and reporters discussed Apple's accounting conundrum (Exhibit 4).

> "Apple said it is required under generally accepted accounting principles to charge customers for the software upgrade. "The nominal distribution fee for the 802.11n software is required in order for Apple to comply with generally accepted accounting principles for revenue recognition, which generally require that we charge for significant feature enhancements, such as 802.11n, when added to previously purchased products."" Source: CNET News.com January 18, 2007.

> "Apple is blaming the Generally Accepted Accounting Principles (GAAP), a set of standards, conventions and rules that accountants follow. Apple claims that those rules require the firm to charge for significant product updates – such as providing next generation wireless networking. Leave it to the accountants to spoil a good thing. In the heads of the bean counters, shipping a feature in disabled mode without telling the buyer and then enabling it at a later point amounts to shipping them a free 802.11n wireless networking card." Source: SiliconValleySleuth.com.

Revenue Recognition for Apple TV and the iPhone

A few months later, Apple announced its revenue recognition policy for the recently shipped Apple TV and its forthcoming iPhone.

> "In March 2007, the Company began shipping Apple TV and expects to begin shipping the iPhone in late June 2007. For Apple TV and the iPhone, the Company plans to provide future unspecified features and additional software products free of charge to customers. Accordingly, the sale of the Apple TV and the iPhone handset are accounted for under subscription accounting in accordance with Statement of Position ("SOP") No. 97-2. As

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[3] The usual allowances were made for expected sales returns, uncollectible accounts and warranty costs.

> such, the Company defers the associated revenue and cost of goods sold at the time of sale, which will then be recognized on a straight-line basis over the currently estimated 24 month economic life of these products. Costs incurred by the Company for engineering, sales, and marketing will continue to be expensed as incurred." Source: Apple, Inc. 10-Q, May 10, 2007. (See Exhibit 5 for management's further discussion of revenue recognition.)

In short, Apple elected to use subscription accounting similar to that used by magazines. When a customer orders and pays for a 2-year magazine subscription, the magazine records the increase in cash but defers the associated revenue as a liability. Revenue is earned and cost of sales is expensed ratably over the two-year period as each magazine ships.

In an interview with the *New York Times*, Apple CFO Peter Oppenheimer said "Apple planned to regularly add new software features to iPhones after they are sold, at no charge, and would alter its accounting policies to make this possible." Further, CEO Steve Jobs indicated that upgrades gave the iPhone an advantage since software in other phones generally remained unchanged.[4]

Why did Apple switch to a subscription model for revenue recognition for its two newest products? Was it merely a response to the negative reaction to the $1.99 fee it charged customers to activate next-generation wireless on their previously purchased laptops?

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[4] Peter Oppenheimer is Apple's CFO and Steve Jobs is CEO. Source: "Apple Zooms Past Rivals, With 88% Profit Growth," *NYT*, April 26, 2007

Case Questions:

1. Apple's fiscal third quarter ends on June 30. Estimate the amount of revenue Apple recorded for its fiscal third quarter on the sale of a single $599 iPhone on June 30, 2007. What amount of revenue *would* Apple have recorded for this same phone in the same fiscal third quarter had all revenue had been recognized at the point-of-sale?

2. Compared to the typical point-of-sale method, what are the likely effects on revenue, gross profit and operating cash flow in future quarters from Apple's choice to use a subscription model for revenue recognition for the iPhone and Apple TV? (No calculations are necessary.)

3. Could Apple have structured sales of Apple TV and the iPhone to avoid 'subscription accounting'? If so, how?

4. Assuming Apple could have avoided 'subscription accounting' for revenue recognition, speculate as to why Apple management might have preferred subscription accounting anyway.

5. As an analyst evaluating Apple's success, how would you compare Apple's sales and gross profit across time and to other companies? (No calculations are necessary.)

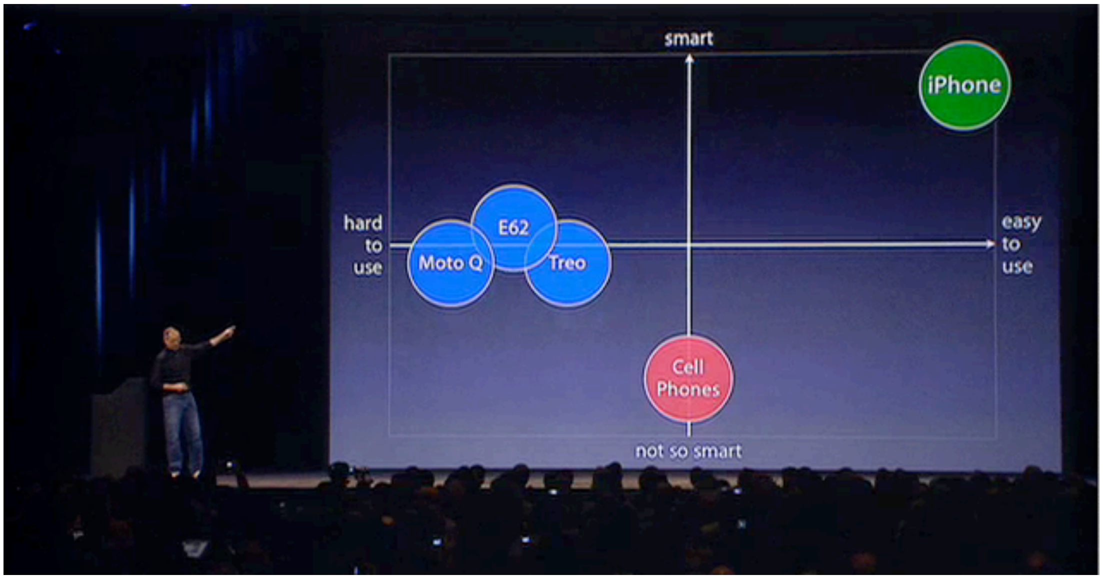
6. Speculate on Apple's likely reasons for *not* using a subscription revenue recognition model for the iPod.

Exhibit 1: iPhone introduced by Apple CEO Steve Jobs at MacWorld, January 9, 2007

Source: http://uk.gizmodo.com/

Source: http://www.apple.com/iphone/

Exhibit 2: Apple CEO Steve Jobs compares iPhone to competitor products, January 9, 2007



"Every once and a while a revolutionary product comes along that changes everything"
Apple CEO Steve Jobs, January 9, 2007, http://www.apple.com/quicktime/qtv/mwsf07/

Exhibit 3: Apple's fiscal third quarter 2007 income statement

APPLE INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (Unaudited)
(in millions, except share and per share amounts)

	Three Months Ended		Nine Months Ended	
	June 30, 2007	July 1, 2006	June 30, 2007	July 1, 2006
Net sales	$ 5,410	$ 4,370	$ 17,789	$ 14,478
Cost of sales (1)	3,415	3,045	11,725	10,292
Gross margin	1,995	1,325	6,064	4,186
Operating expenses:				
Research and development (1)	208	175	575	533
Selling, general, and administrative (1)	746	584	2,140	1,808
Total operating expenses	954	759	2,715	2,341
Operating income	1,041	566	3,349	1,845
Other income and expense	155	95	429	252
Income before provision for income taxes	1,196	661	3,778	2,097
Provision for income taxes	378	189	1,186	650
Net income	$ 818	$ 472	$ 2,592	$ 1,447

Exhibit 4: Article about Apple's accounting for the wi-fi 'N-standard' upgrade fee

cnet NEWS.com

Apple's 802.11n accounting conundrum

By Tom Krazit
Staff Writer, CNET News.com
Published: January 19, 2007, 6:56 PM PST

news analysis Apple's explanation of a planned Wi-Fi upgrade fee has its roots in obscure accounting rules that tell companies how to book sales of future product upgrades.

Apple said Thursday that it plans to charge customers $1.99 for a software download that enables the 802.11n Wi-Fi technology currently present in almost all MacBooks and MacBook Pros with Intel's Core 2 Duo processor. The company says accounting rules known as generally accepted accounting principles (GAAP) force it to ask for money for the download.

"During the past several months Apple has shipped some Macs with the hardware to support 802.11n, but the draft of the 802.11n specification was not complete enough to create the required software," Apple spokeswoman Lynn Fox said in an e-mail to CNET News.com. "Now that the draft specification is complete, we are ready to distribute the software to make the 802.11n hardware in these Macs come to life."

But because the company has already recognized all the revenue from the sales of those computers, it has to now charge customers at least a nominal fee in order to establish the value of its software upgrade and satisfy an obscure accounting regulation known as SOP 97-2, said Fox.

Apple didn't have to do it this way, say accounting experts. But the company most likely faced difficult choices in relation to the upgrade: It could have held off on shipping the new Macs until the upgrade software was ready. It could have skipped the 802.11n capabilities altogether. Or it could have deferred revenue from the new Macs until the software was ready--all unlikely and unpalatable options.

Hence, the $1.99 fee.

Of course, back when the Macs first shipped, Apple could have told customers that the upgrade cost was coming and avoided customer backlash over the surprise fee, but that didn't happen either.

"To be certain, GAAP does not require companies to charge customers," said Gerard Carney, a spokesman for the Financial Accounting Standards Board (FASB), which updates and maintains GAAP standards for accounting. "Further, GAAP does not tell companies how to run their business," he wrote in an e-mail.

And now, for the tricky part... The 802.11n Wi-Fi standard delivers faster wireless connection speeds and greater network range. It has been delayed a few times, but the Wi-Fi Alliance, a group of companies charged with managing the standard, is getting ready to certify products based on the specification. Apple announced at its recent Macworld Expo in San Francisco that it would start shipping a new 802.11n Airport Extreme Base Station and the upgrade software for $179 in February, around the same time it will ship its Apple TV product, which also has an 802.11n chip.

Apple began selling MacBook Pro notebooks with Intel's Core 2 Duo processor in September, later adding that chip to MacBooks and iMacs. However, the company also included 802.11n chips in almost all of those systems without telling buyers, Apple CEO Steve Jobs revealed at Macworld last week.

Here comes the tricky part: under accounting regulations developed over the last several years, when companies sell a product with multiple pieces that are delivered at different times, they must determine the separate value of each piece of that product, accounting experts say. And the company can only record the revenue associated with a specific piece when it is delivered to the customer.

This is a very common practice in many industries, said Ryan LaFond, assistant professor for accounting at the Massachusetts Institute of Technology's Sloan School of Business. For example, magazines receive all the money for a full year's subscription at the time the subscription is purchased, but they only record that as revenue as each issue is delivered, deferring the remaining balance into a liability account called unearned revenue.

But magazine readers purchase a subscription knowing they'll get an issue every week or month, which establishes the value of each issue and lets the accountants know how much money to recognize as revenue each month.

In order to figure out how much revenue can be booked up front, companies need what's called "vendor-specific objective evidence" of the value of the separate pieces of software. In other words, they need to prove how much each piece of software would be worth if it was sold separately, as opposed to how much it's worth in a package deal with other pieces of software.

The problem is you can't prove what some things are worth until you sell them. What's the value of a software upgrade to 802.11n on the open market? Apple isn't going to let any other company sell software that would upgrade a piece of its hardware, making it almost impossible to establish a market value for that software.

That means a company in this situation would have to defer all the revenue associated with the product until it can establish the value of the Wi-Fi upgrade, or until it delivers the complete set of software, said Brett Trueman, a professor of accounting with the Anderson Business School at the University of California at Los Angeles. So, Apple would have had to defer all the revenue for Macs sold with the 802.11n chips from September until it delivers the upgrade in February, and that's not a realistic option.

So now, Apple has to establish a value for the Wi-Fi upgrade in order to satisfy the requirement to separately account for the different pieces of software. One easy way to do that is to charge people for it.

There's absolutely nothing in the GAAP requirements that says Apple must charge its customers for that software upgrade. The only requirement imposed by GAAP is that Apple must account for the separate value of the 802.11n capability, said MIT's LaFond. It can do this by creating a value at the time of purchase or it can wait until it delivers that capability to record all the revenue associated with the product.

Another option, if the company had wanted to keep the 802.11n capabilities secret, is to create a "new arrangement" with the customer. Apple sold the customer a notebook in September, and is now selling the customer 802.11n capabilities for that notebook. These are two separate transactions that satisfy the need to account for the undelivered 802.11n capability as well as Apple's desire to book all the revenue for the notebook up front and keep the use of the 802.11n chip a secret.

Any of those options would satisfy Apple's need to account for the separate delivery times for the Macs and the 802.11n capabilities, according to several experts interviewed for this article. But simply blaming the fee on GAAP, or on the Sarbanes-Oxley regulations as some rumors have suggested, does not tell the full story.

"If I'm a company, and I want to give my customer something, GAAP isn't going to prevent you from doing that," LaFond said. But at a time when Apple's accounting practices are under significant scrutiny from regulators looking into the company's stock-options backdating practices, the company has to be extra careful about following the proper procedures while keeping financial analysts happy with strong earnings reports.

Exhibit 5: Excerpt from Management's Discussion and Analysis of Financial Condition and Results of Operations, Apple Inc. 10-Q, May 10, 2007

Revenue Recognition

Net sales consist primarily of revenue from the sale of hardware, software, peripherals, digital content, and service and support contracts. The Company recognizes revenue for software products (operating system software and applications software), or any product that is considered to be software-related in accordance with the guidance in EITF No. 03-5, Applicability of American Institute of Certified Public Accountants ("AICPA") Statement of Position 97-2 to Non-software Deliverables in an Arrangement Containing More-Than-Incidental Software, (e.g., Macintosh computers and iPod portable digital music players) pursuant to AICPA Statement of Position ("SOP") No. 97-2, Software Revenue Recognition, as amended. For products that are not software or software-related, (e.g., digital content sold on the iTunes Store and certain Macintosh and iPod supplies and accessories) the Company recognizes revenue pursuant to SEC Staff Accounting Bulletin ("SAB") No. 104, Revenue Recognition.

The Company recognizes revenue when persuasive evidence of an arrangement exists, delivery has occurred, the sales price is fixed or determinable, and collection is probable. Product is considered delivered to the customer once it has been shipped, and title and risk of loss have been transferred. For most of the Company's product sales, these criteria are met at the time the product is shipped. For online sales to individuals, for some sales to education customers in the U.S., and for certain other sales, the Company defers revenue until the customer receives the product because the Company retains a portion of the risk of loss on these sales during transit. If at the outset of an arrangement the Company determines the arrangement fee is not, or is presumed not to be, fixed or determinable, revenue is deferred and subsequently recognized as amounts become due and payable and all other criteria for revenue recognition have been met.

In March 2007, the Company began shipping Apple TV and expects to begin shipping the iPhone in late June 2007. For Apple TV and the iPhone, the Company plans to provide future unspecified features and additional software products free of charge to customers. Accordingly, the sale of the Apple TV and the iPhone handset are accounted for under subscription accounting in accordance with Statement of Position ("SOP") No. 97-2. As such, the Company defers the associated revenue and cost of goods sold at the time of sale, which will then be recognized on a straight-line basis over the currently estimated 24 month economic life of these products. Costs incurred by the Company for engineering, sales, and marketing will continue to be expensed as incurred.