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Accounting for the iPhone at Apple Inc.

On October 21, 2008, Apple Inc. announced financial results for Q4 of FY 2008 ended September 27, 2008 (see **Exhibit 1**). Under the U.S. generally accepted accounting principles (GAAP), Apple reported quarterly revenue of $7.9 billion and net profit of $1.1 billion. For the first time, the Cupertino, California-based company included non-GAAP measures in its earnings announcement to supplement its U.S. GAAP financial results. Apple's non-GAAP quarterly revenue and net profit were $11.7 billion and $2.4 billion, respectively. As Apple CEO Steve Jobs noted, "As you can see, the non-GAAP financial results are truly stunning."[1] He explained the change in a rare appearance on the company's earnings conference call later that day:

> I would like to . . . talk about the non-GAAP financial results, because I think this is a pretty 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. 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 the past quarter, as you heard, 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.[2]

Jobs also noted that in terms of non-GAAP mobile-phone revenue, in just 15 months Apple had become the world's third-largest phone manufacturer behind Nokia and Samsung but ahead of Sony Ericsson, LG, Motorola, and RIM.

Company Background

Jobs and Steve Wozniak launched the personal computer revolution in the 1970s with the Apple II. In 1984, the Apple Macintosh, with its ease-of-use and brilliant design, redefined the personal computer. Shortly thereafter, Jobs left the company, returning in 1997. Under Jobs, Apple catalyzed the digital-media industry with the launch of its iPod portable musical player in October 2001, followed by the introduction of its iTunes online store in April 2003.

Professors Francois Brochet and Krishna G. Palepu and Research Associate Lauren Barley prepared this case. This case was developed from published sources. HBS cases are developed solely as the basis for class discussion. Cases are not intended to serve as endorsements, sources of primary data, or illustrations of effective or ineffective management.

In June 2007, the company entered the highly competitive mobile-phone market with its iPhone, the first smartphone (a combination of a phone and a mini-computer) with a touch-screen interface and the company's new mobile operating system, iOS. Several months later, Apple released the iPod touch (an iPhone without the phone capability).

Apple released its iPhone 3G in July 2008 along with its second-generation mobile operating system (iOS 2). Also in July 2008, Apple introduced its App Store, which offered iPhone and iPod touch users a wide variety of mobile applications ranging from games to social networking to productivity tools, mostly priced under $10. On July 14, 2008, Jobs noted, "The App Store is a grand slam, with a staggering 10 million applications downloaded in just three days. Developers have created some extraordinary applications, and the App Store can wirelessly deliver them to every iPhone and iPod touch user instantly."[3] Many of the applications took advantage of the more robust iOS 2. By October 2008, Apple was best known for its technical and design innovation, its "walled garden" approach (i.e., its mostly proprietary ecosystem of hardware, operating and application software, and peripherals), and its premium-priced products.

iPhone Business Model

The original iPhone 8GB model had a U.S. retail price of $399 and was available through Apple and AT&T, the iPhone's exclusive U.S. mobile carrier. In the U.S., mobile carriers typically provided subsidies to phone manufacturers, which lowered the purchase price of the new phone. In exchange, most consumers signed a two-year service contract with the carriers. Apple and AT&T agreed to a different arrangement, but did not disclose its specifics. AT&T did not subsidize the iPhone; instead, Apple signed a revenue-sharing agreement with AT&T that gave Apple a share of the subscribers' monthly service fees. Needham & Co. analyst Charles Wolf believed that AT&T paid Apple $10 per month over a typical two-year contract.[4] In addition, although Apple did not disclose how much it sold the iPhone for to AT&T, analysts believed that Apple made an estimated $120 in gross profit on every iPhone sold.[5]

At the iPhone's launch, Apple announced it might periodically offer new software updates and upgrades free of charge to its iPhone customers. In contrast, Mac and iPod users did not receive free software features and upgrades. For example, users were charged $129 to upgrade to the new Mac operating system (Mac OS X Leopard) in October 2007, whereas Apple planned to provide newer versions of the iPhone operating system free of charge to all iPhone users. Apple's chief financial officer Peter Oppenheimer explained, "Since iPhone customers will likely be our best advocates for the product, we want to get them many of these new features and applications at no additional charge as they become available."[6]

In addition, Apple's management knew that smartphone users were slow to update their software, and that few opted to buy upgrades. Therefore, the company believed it was necessary to offer new software features free of charge to increase user acceptance. In contrast, most other mobile software vendors reserved new software updates for new hardware (i.e., phone) releases.[7] Apple, AT&T, third-party application developers, and users would all benefit from consumers' use of the latest operating system and applications, giving Apple and its ecosystem a competitive advantage. AT&T would run a more effective and efficient mobile network; third-party software developers would have a stable hardware and software roadmap; Apple could delist applications from its App Store that weren't written for its latest operating system; and all the while, iPhone users would benefit from an evolving and differentiated set of features and functionality. Many users of competing mobile-phone platforms could not upgrade to newer operating systems and applications because of compatibility issues with their phones.

When Apple launched the iPhone 3G in July 2008, it revamped its business model, bringing it more in line with industry practices. Apple gave up its share of the monthly service revenue in exchange for AT&T subsidizing the price of the iPhone 3G, which sold for $199 at retail. Again, the two parties chose not to disclose the specifics of their arrangement, but the subsidy was estimated at $300 per phone sold.[8] Apple continued to differ from most other industry participants when it offered existing iPhone users upgrades to its second-generation operating system at no cost.

By August 2008, a month after Apple introduced its App Store, Jobs noted that users downloaded more than 60 million programs for the iPhone, and Apple was averaging $1 million a day in application-software revenue. Apple received 30% of the App Store revenue from the sale of an iPhone application, and the developer received the remaining 70%.[9] Jobs stated, "Phone differentiation used to be about radios and antennas and things like that. We think, going forward, the phone of the future will be differentiated by software."[10]

Also in August 2008, the *New York Times* reported that T-Mobile would be the first carrier to launch mobile phones using Google's Android mobile operating system; the phones were expected to hit shelves in late October 2008. On October 21, 2008, Google announced that Android was now "the first free, open source, and fully customizable mobile platform."[11]

iPhone Revenue Recognition

Software-enabled hardware devices (also known as "bundled components"), such as Apple's iPhone, Macs, and iPods, fell under the software revenue recognition rules pursuant to American Institute of Certified Public Accountants (AICPA) Statement of Position (SOP) No. 97-2, Software Revenue Recognition. When Apple first introduced the iPhone in 2007, the company announced it would use the "subscription method of accounting" under SOP No. 97-2 to book revenue for its new iPhone. Oppenheimer explained:

> Since we will be periodically providing new software features to iPhone customers free of charge, we will use subscription accounting and recognize the revenue and product cost of goods sold associated with iPhone handset sales on a straight line basis over 24 months. So while the cash from iPhone sales will be collected at the time of sale, we will be recording deferred revenue and costs of goods sold on our balance sheet, and amortizing both of them into our earnings on a straight line basis over 24 months. We will continue to expense our iPhone engineering, sales, and marketing costs as we incur them. This accounting policy will have no impact on cash flow or the economics of our business.[12]

In contrast, Apple generally recognized revenue and cost of sales for its other software-enabled hardware products such as Macs and iPods at the time of sale (i.e., immediate revenue recognition) under SOP No. 97-2. This was because the company did not provide new features or software applications for those products free of charge. (See **Exhibit 2** for the FY 2008 financial statement note relating to Apple's revenue recognition policies under GAAP.)

Apple's decision to use subscription accounting for the iPhone came soon after the company faced consumer backlash over a $5 upgrade fee (later reduced to $1.99) it charged new MacBook buyers.[13] In 2006, Apple sold its latest MacBook with a wireless chip that would allow users to access the new and better Wi-Fi 802.11n technology once it became available and the chip was activated with software. Apple did not tell MacBook buyers about the chip's existence, and it also recognized all revenue at the time the MacBooks sold. Thus, the chip and its activation software were an unspecified, future upgrade that did not have an established, objective, separate value (which would have allowed it to be accounted for separately) at the time of the MacBook sale. To comply with GAAP, Apple faced two options: 1) restate its financials to recognize the MacBook revenue under subscription accounting, or 2) charge users for the upgrade. The company chose the latter option.

Technology companies such as Apple were increasingly facing the issue of how to account for bundled components as the software and hardware in these products became more integrated and integral to the products' function. This placed U.S. technology companies on unequal footing with their overseas competitors because International Financial Reporting Standards (IFRS) allowed companies to use a more subjective measure—cost plus margin—when an objective and separate value could not be established for a future deliverable such as a free software upgrade. Consequently, an overseas company could report more than a fraction of its revenue when it sold a bundled component with the promise of a future deliverable such as a free upgrade. Company management could estimate the cost and the margin of the upgrade and defer just that portion of the bundled component's sale until the upgrade was delivered.[14]

Subscription Accounting

The software and magazine publishing industries were well known for their use of subscription accounting. Magazine publishers reported the cash received for a subscription at the time that the subscription was purchased, but recorded the revenue only as each issue was delivered. The remaining balance was deferred into a liability account called unearned (or deferred) revenue. For example, if a year's subscription of a monthly magazine cost $12, then the magazine publisher would recognize $1 per month in revenue for 12 months as the unearned revenue account decreased by $1 per month.

Under subscription accounting, Apple recognized the associated revenue and cost of goods sold for the iPhone on a straight-line basis over the product's estimated 24-month economic life (the typical length of a mobile phone service contract). When Apple announced its quarterly results from iPhone sales, its reported revenues (and other related metrics) reflected only an eighth of the revenue from iPhone sales during that quarter. This resulted in a deferral of the remaining revenue and cost of sales relating to iPhones units sold, although the company received and reported the cash in the quarter of the sale. Each quarter, Apple also reported a share of iPhone sales (both the revenue and the associated cost of goods sold) for iPhones sold in previous quarters. (See **Exhibit 3** for an illustration of iPhone subscription accounting.) As long as the number of iPhone sales increased each quarter, the deferral balance increased. Costs incurred for engineering, sales, marketing, and warranty were expensed as incurred.

Reactions

In July 2008, iPhone users validated Apple's decision to offer free upgrades when they quickly adopted the free iOS 2. Apple never intended to give iPod touch users upgrades at no charge, and its users expressed confusion and dissatisfaction with their $9.95 upgrade fee for the same software.[15] At the same time, Apple's use of subscription accounting drew mixed reviews from the business community. A *Business Finance* article praised Apple's "smoother revenue curve" that resulted from its use of subscription accounting, saying, "Apple shows how a mature, astute organization can use revenue accounting rules to its benefit."[16] However, an *Apple 2.0 Fortune Tech* post stated:

> More than seven months have passed [since Apple's use of subscription accounting began] and nobody—not the analysts, not the investors, and certainly not Wall Street—has quite wrapped their mind around what this bookkeeping oddity means for Apple's bottom line. That's in part because it's complicated, and in part because Apple hasn't provided all the data you would need to fully assess its impact.
>
> But those so-called deferred earnings are adding up, and some professional Apple watchers are starting to realize that their impact could be substantial …. And to the dismay of Apple shareholders, the fact that these deferred earnings are piling up seems to have gone right over the heads of the institutional investors who have driven Apple shares down nearly 75 points since December.[17] [See **Exhibit 4** for quarterly deferred earning balances.]

Non-GAAP Supplements

By the fourth quarter of 2008, Apple's management believed the impact of subscription accounting on its financials was too big for the company to ignore. Apple released select Q4 of FY 2008 non-GAAP financial results as supplements that gave Apple watchers their first look at its revenue numbers without the use of subscription accounting. Research suggested that companies issued non-GAAP supplementary disclosures to communicate adjusted accounting numbers that better predicted future performance, but also for opportunistic reasons.[18] On average, investors appeared to weight non-GAAP numbers more heavily compared to GAAP numbers when they formed their expectations for future earnings, assuming they found the non-GAAP numbers informative and credible. Not surprisingly, research also showed that companies tended to emphasize measures that portrayed the most favorable performance.[19]

In 2003, the Securities and Exchange Commission (SEC) issued new non-GAAP disclosure rules to address concerns about the lack of oversight on these disclosures. The SEC's Regulation G required companies that disclosed non-GAAP financial measures to use the most comparable GAAP measures when preparing their non-GAAP disclosures, in addition to providing a reconciliation of the GAAP and non-GAAP results.[20] Recent studies indicated that since the passage of Regulation G, firms were less likely to provide non-GAAP earnings that excluded expenses of a recurring nature.[21]

In describing Apple's non-GAAP financials, Jobs noted that iPhone non-GAAP sales were a staggering $4.6 billion, 39% of Apple's total revenue in the fourth quarter of 2008. See **Table A**.

Table A

Q4 2008	GAAP ($ billions)	Non-GAAP ($ billions)	% Increase
Total Sales	$7.9	$11.7	48%
Total Income	1.1	2.4	115%
iPhone Sales	0.8	4.6	475%
iPhone as % of Sales	10%	39%	

Source: Casewriter.

Apple cautioned that its non-GAAP calculations did not adjust for the estimated costs associated with its plan to provide new features and software upgrades to iPhone buyers free of charge. It also warned investors that these figures were not prepared under a comprehensive set of rules or principles, since no standards existed for making these calculations. (See **Exhibit 5** for Apple's cautions on use of its non-GAAP supplements.)

Apple also announced iPhone Q4 of FY 2008 GAAP sales that just missed Wall Street's estimates, but total income that easily beat analysts' estimates.[22] Apple's guidance for the first quarter of FY 2009 was well below Wall Street's forecast. Apple's stock closed down for the day.

Conclusion

The immediate analyst reaction to Apple's Q4 of FY 2008 financial results and conservative Q1 of FY 2009 guidance was largely positive, although Maynard Um of UBS downgraded his rating from "Buy" to "Neutral" and cut his share price target to $115 (from $125), citing "potential macro-economic issues impacting Mac sales."[23] In contrast, Shebly Seyrafi of Calyon Securities raised his rating from "Add" to "Buy" and increased his price target to $150 (from $130), noting that Apple's earnings per share (EPS) would have more than doubled had it not been for the company's use of subscription accounting for iPhone sales.[24] (See **Exhibit 6** for share price performance.)

Reaction to Apple's decision to provide non-GAAP supplements was more mixed. Proponents of Apple's use of non-GAAP supplements argued that these results were more consistent with Apple's $24.5 billion in cash and short-term investments. Under GAAP, they pointed out, the iPhone's strong shipments in Q4 of FY 2008 were not fully reflected in Apple's results. They also contended that valuations using non-GAAP measures were better indicators of the company's true financial performance.[25]

In contrast, GAAP proponents asserted that the Street penalized technology companies reporting non-GAAP results. They argued that Apple's management clearly believed future, free software upgrades were critical to an iPhone buyer's initial purchase decision and necessitated Apple's use of subscription accounting. Further, they argued that non-GAAP supplements gave the iPhone too much weight, pointing to the fact that Apple's quarterly numbers became more sensitive to iPhone unit sales, which were more volatile and difficult for analysts to predict. Perhaps most importantly, they maintained that investors knew to use cash revenue numbers for valuations and ratios, and that changing to non-GAAP measures should have no impact on the economic value of Apple shares.[26]

Apple announced that it would continue to provide non-GAAP supplements during earnings releases. Only time would reveal their effects, if any, on Apple's share pricing.

Exhibit 1 Apple Inc. Select Historical Financial Data

1a. Apple Inc. Q4 2008 Unaudited Summary Data

	Q3 2008		Q4 2007		Q4 2008		Sequential Change		Year/Year Change	
	CPU Units (K)	Revenue ($M)	CPU Units (K)	Revenue ($M)	CPU Units K	Revenue ($M)	CPU Units	Revenue	CPU Units	Revenue
Product Summary										
Desktops[a]	943	$1,373	817	$1,195	936	$1,363	-1%	-1%	15%	14%
Portables[b]	1,553	2,237	1,347	1,908	1,675	2,257	8%	1%	24%	18%
Subtotal CPUs	**2,496**	**3,610**	**2,164**	**3,103**	**2,611**	**3,620**	**5%**	**0%**	**21%**	**17%**
iPod	11,011	1,678	10,200	1,619	11,052	1,660	0%	-1%	8%	3%
Other Music-Related Products and Services[c]		819		601		832		2%		38%
iPhone and Related Products and Services[d]	717	419	1,119	118	6,892	806	861%	92%	516%	583%
Peripherals and Other Hardware		437		346		428		-2%		24%
Software, Service and Other Sales		501		430		549		10%		28%
Total Apple		**$7,464**		**$6,217**		**$7,895**		**6%**		**27%**

Source: "Apple Reports Fourth Quarter Results," October 21, 2008, http://www.apple.com/pr/library/2008/10/21results.html, accessed June 22, 2010.

Notes: K = units in thousands; $M = amounts in millions.

[a] Includes iMac, Mac mini, Mac Pro, PowerMac, and Xserve product lines.

[b] Includes MacBook, iBook, MacBook Air, MacBook Pro, and PowerBook product lines.

[c] Consists of iTunes Store sales, iPod services, and Apple-branded and third-party iPod accessories.

[d] Units consist of iPhone handset sales; revenue is derived from handset sales, carrier agreements, and Apple-branded and third-party iPhone accessories.

Exhibit 1 (continued)

1b. Apple Inc. Unaudited Condensed Consolidated Statement of Operations (in millions, except share amounts, which are reflected in thousands and per-share amounts)

	Three Months Ended:		Twelve Months Ended:	
	September 27, 2008	**September 29, 2007**	**September 27, 2008**	**September 29, 2007**
Net sales	$7,895	$6,217	$32,479	$24,006
Cost of sales[a]	5,156	4,127	21,334	15,852
Gross margin	2,739	2,090	11,145	8,154
Operating expenses:				
Research and development[a]	298	207	1,109	782
Selling, general, and administrative[a]	999	823	3,761	2,963
Total operating expenses	1,297	1,030	4,870	3,745
Operating income	1,442	1,060	6,275	4,409
Other income and expense	140	170	620	599
Income before provision for income taxes	1,582	1,230	6,895	5,008
Provision for income taxes	446	326	2,061	1,512
Net income	$1,136	$904	$4,834	$3,496
Earnings per common share:				
Basic	$1.28	$1.04	$5.48	$4.04
Diluted	$1.26	$1.01	$5.36	$3.93
Shares used in computing earnings per share:				
Basic	887,110	870,881	881,592	864,595
Diluted	904,786	895,666	902,139	889,292
[a]Includes stock-based compensation expense as follows:				
Cost of sales	$21	$10	$80	$35
Research and development	$52	$21	$185	$77
Selling, general, and administrative	$68	$37	$251	$130

Source: "Apple Reports Fourth Quarter Results," October 21, 2008, http://www.apple.com/pr/library/2008/10/21results.html, accessed June 22, 2010.

Exhibit 1 (continued)

1c. Unaudited Condensed Balance Sheets (in millions, except share amounts)

	September 27, 2008	September 29, 2007
ASSETS:		
Current Assets:		
Cash and cash equivalents	$11,875	$9,352
Short-term investments	12,615	6,034
Accounts receivable, less allowances of $47 in each period	2,422	1,637
Inventories	509	346
Deferred tax assets	1,447	782
Other current assets[a]	5,822	3,805
Total current assets	34,690	21,956
Property, plant, and equipment, net	2,455	1,832
Goodwill	207	38
Acquired intangible assets, net	285	299
Other assets[b]	1,935	1,222
Total Assets	$39,572	$25,347
LIABILITIES AND SHAREHOLDERS' EQUITY:		
Current Liabilities:		
Accounts payable	$5,520	$4,970
Accrued expenses[c]	8,572	4,310
Total current liabilities	14,092	9,280
Non-current liabilities[d]	4,450	1,535
Total Liabilities	18,542	10,815
Commitments and contingencies		
Shareholders' Equity:		
Common stock, no par value	7,177	5,368
Retained earnings	13,845	9,101
Accumulated other comprehensive income	8	63
Total Shareholders' Equity	21,030	14,532
Total Liabilities and Shareholders' Equity	$39,572	$25,347

Source: "Apple Reports Fourth Quarter Results," October 21, 2008, http://www.apple.com/pr/library/2008/10/21results.html, accessed June 22, 2010.

Notes:

[a] Includes current portion of deferred costs under subscription accounting of $1,931 million and $247 million, respectively.

[b] Includes non-current portion of deferred costs under subscription accounting of $1,089 million and $214 million, respectively.

[c] Includes current portion of deferred revenue under subscription accounting of $4,853 million and $1,391 million, respectively.

[d] Includes non-current portion of deferred revenue under subscription accounting of $3,029 million and $849 million, respectively.

Exhibit 1 (continued)

1d. Unaudited Condensed Consolidated Statements of Cash Flows (in millions)

Twelve Months Ended:	September 27, 2008	September 29, 2007
Cash and cash equivalents, beginning of the period	$9,352	$6,392
Operating Activities:		
Net income	4,834	3,496
Adjustments to reconcile net income to cash generated by operating activities:		
Depreciation, amortization, and accretion	473	317
Stock-based compensation expense	516	242
Provision for deferred income taxes	(368)	78
Loss on disposition of property, plant, and equipment	22	12
Changes in operating assets and liabilities:		
Accounts receivable, net	(785)	(385)
Inventories	(163)	(76)
Other current assets	(1,958)	(1,540)
Other assets	(492)	81
Accounts payable	596	1,494
Deferred revenue	5,642	1,139
Other liabilities	1,279	612
Cash generated by operating activities	9,596	5,470
Investing Activities:		
Purchases of short-term investments	(22,965)	(11,719)
Proceeds from maturities of short-term investments	11,804	6,483
Proceeds from sales of short-term investments	4,439	2,941
Purchases of long-term investments	(38)	(17)
Payments made in connection with business acquisitions, net of cash acquired	(220)	--
Payment for acquisition of property, plant, and equipment	(1,091)	(735)
Payment for acquisition of intangible assets	(108)	(251)
Other	(10)	49
Cash used in investing activities	(8,189)	(3,249)
Financing Activities:		
Proceeds from issuance of common stock	483	365
Excess tax benefits from stock-based compensation	757	377
Cash used to net share settle equity awards	(124)	(3)
Cash generated by financing activities	1,116	739
Increase in cash and cash equivalents	2,523	2,960
Cash and cash equivalents, end of the period	$11,875	$9,352
Supplemental cash flow disclosure:		
Cash paid for income taxes, net	$1,267	$863

Source: "Apple Reports Fourth Quarter Results," October 21, 2008, http://www.apple.com/pr/library/2008/10/21results.html, accessed June 22, 2010.

Exhibit 1 (continued)

1e. Unaudited Condensed 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—Noncurrent:			
iPhone and Apple TV	2,262	632	290
AppleCare	651	597	495
Other	116	107	64
Total deferred revenue—Noncurrent	3,029	1,336	849
Total deferred revenue	$7,882	$4,063	$2,240

Source: "Apple Reports Fourth Quarter Results," October 21, 2008, http://www.apple.com/pr/library/2008/10/21results.html, accessed June 22, 2010.

Exhibit 1 (continued)

1f. 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

Source: "Apple Reports Fourth Quarter Results," October 21, 2008, http://www.apple.com/pr/library/2008/10/21results.html, accessed June 22, 2010.

[a] Non-GAAP adjustment to net sales reflect (i) the reversal of the 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 adjustment to cost of sales reflect (i) the reversal of the 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 provision for income taxes.

[e] Represents the after-tax effect of the non-GAAP adjustments to gross margin, operating income, and income before provision for income taxes.

[f] Represents the per-share impact of the non-GAAP adjustments to net income.

Exhibit 2 Apple Inc. FY 2008 Revenue Recognition Policy

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1—Summary of Significant Accounting Policies

Revenue Recognition

Net sales consist primarily of revenue from the sale of hardware, software, music products, digital content, peripherals, and service and support contracts. For any product within these groups that either is software, or is considered software-related in accordance with the guidance in Emerging Issues Task Force ("EITF") No. 03-5, *Applicability of AICPA Statement of Position 97-2 to Non-Software Deliverables in an Arrangement Containing More-Than-Incidental Software* (e.g., Mac computers, iPod portable digital music players, and iPhones), the Company accounts for such products in accordance with the revenue recognition provisions of American Institute of Certified Public Accountants ("AICPA") Statement of Position ("SOP") No. 97-2, *Software Revenue Recognition*, as amended. The Company applies Staff Accounting Bulletin ("SAB") No. 104, *Revenue Recognition,* for products that are not software or software-related, such as digital content sold on the iTunes Store and certain Mac, iPod, and iPhone supplies and accessories.

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 legally 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.

Revenue from service and support contracts is deferred and recognized ratably over the service coverage periods. These contracts typically include extended phone support, repair services, web-based support resources, diagnostic tools, and extend the service coverage offered under the Company's one-year limited warranty.

The Company sells software and peripheral products obtained from other companies. The Company generally establishes its own pricing and retains related inventory risk, is the primary obligor in sales transactions with its customers, and assumes the credit risk for amounts billed to its customers. Accordingly, the Company generally recognizes revenue for the sale of products obtained from other companies based on the gross amount billed.

The Company accounts for multiple element arrangements that consist only of software or software-related products in accordance with SOP No. 97-2. If a multiple-element arrangement includes deliverables that are neither software nor software-related, the Company applies EITF No. 00-21, *Revenue Arrangements with Multiple Deliverables,* to determine if those deliverables constitute separate units of accounting from the SOP No. 97-2 deliverables. If the Company can separate the deliverables, the Company applies SOP No. 97-2 to the software and software-related deliverables and applies other appropriate guidance (e.g., SAB No. 104) to the deliverables outside the scope of SOP No. 97-2. Revenue on arrangements that include multiple elements such as hardware, software, and services is allocated to each element based on the relative fair value of each element. Each element's allocated revenue is recognized when the revenue recognition criteria for that element have been met. Fair value is generally determined by vendor specific objective evidence ("VSOE"), which is based on the price charged when each element is sold separately. If the Company cannot objectively determine the fair value of any undelivered element included in a multiple-element arrangement, the Company defers revenue until all elements are delivered and services have been performed, or until fair value can objectively be determined for any remaining undelivered elements. When the fair value of a delivered element has not been established, the Company uses the residual method to recognize revenue if the fair value of all undelivered elements is determinable. Under the residual method, the fair value of the undelivered elements is deferred and the remaining portion of the arrangement fee is allocated to the delivered elements and is recognized as revenue.

The Company records reductions to revenue for estimated commitments related to price protection and for customer incentive programs, including reseller and end-user rebates, and other sales programs and volume-based incentives. The estimated cost of these programs is accrued as a reduction to revenue in the period the Company has sold the product and committed to a plan. The Company also records reductions to revenue for expected future product returns based on the Company's historical experience. Revenue is recorded net of taxes collected from customers that are remitted to governmental authorities, with the collected taxes recorded as current liabilities until remitted to the relevant government authority.

Generally, the Company does not offer specified or unspecified upgrade rights to its customers in connection with software sales or the sale of extended warranty and support contracts. When the Company does offer specified upgrade rights, the Company defers revenue for the fair value of the specified upgrade right until the future obligation is fulfilled or when the right to the specified upgrade expires. Additionally, a limited number of the Company's software products are available with maintenance agreements that grant customers rights to unspecified future upgrades over the maintenance term on a when and if available basis. Revenue associated with such maintenance is recognized ratably over the maintenance term.

In 2007, the Company began shipping Apple TV and iPhone. For Apple TV and iPhone, the Company indicated it may from time-to-time provide future unspecified features and additional software products free of charge to customers. Accordingly, Apple TV and iPhone handsets sales are accounted for under subscription accounting in accordance with SOP No. 97-2. As such, the Company's policy is to defer the associated revenue and cost of goods sold at the time of sale, and recognize both on a straight-line basis over the currently estimated 24-month economic life of these products, with any loss recognized at the time of sale. Costs incurred by the Company for engineering, sales, marketing, and warranty are expensed as incurred.

Source: Apple Inc. 10-K, November 05, 2008.

Exhibit 3 Illustration of iPhone Subscription Accounting

Assume Apple sold the iPhone 3G for $500 (AT&T subsidy of $300 + retail price of $200), and the gross profit was $150 per unit (30%). The subscription accounting for the sale would be as follows:

Q1 (quarter in which iPhone was sold to consumer):

Dr. Cash		500	
	Cr. Revenue		62.5
	Cr. Deferred Revenue under Subscription Accounting		437.5
Dr. COGS		43.75	
Dr. Deferred Costs under Subscription Accounting		306.25	
	Cr. Inventory		350

Q2 to Q8 (remaining quarters of iPhone's economic life):

Dr. Deferred Revenue under Subscription Accounting		62.5	
	Cr. Revenue		62.5
Dr. COGS		43.75	
	Cr. Deferred Costs under Subscription Accounting		43.75

Source: Casewriter.

Note: iPhone costs incurred for engineering, sales, marketing, and warranty were expensed as incurred.

Exhibit 4 Apple Inc. Quarterly Deferred Revenue Balances ($ millions)

	9/08	6/08	3/08	12/07	9/07	6/07	3/07	9/06
Current deferred revenue	4,853	2,727	2,416	2,059	1,391	1,063	903	718
Noncurrent deferred revenue	3,029	1,336	1,409	1,229	849	561	433	383
Total deferred revenue	7,882	4,063	3,825	3,288	2,240	1,624	1,336	1,101

Source: Adapted by casewriter from Apple Inc. Quarterly 10Qs.

Note: Apple did not include quarterly deferred cost balances in its 10Qs.

Exhibit 5 Apple's "Cautions on Use of Non-GAAP Measures"

As noted previously, these non-GAAP financial measures are not consistent with GAAP because they do not reflect the deferral of revenue and product costs for recognition in later periods. These non-GAAP financial measures do not adjust for the costs associated with the Company's intention to provide unspecified new features and software to purchasers of iPhone and Apple TV products. These costs are expensed as incurred under GAAP's subscription accounting model, and are not adjusted in these non-GAAP financial measures. As such, these non-GAAP financial measures are not intended to reflect in a given period all of the costs of sales made in that period. Rather, the non-GAAP financial measures presented below are intended for the limited purpose of presenting performance measures that include the total sales, related product costs, and resulting income for iPhones and Apple TVs in the period those products are sold to customers.

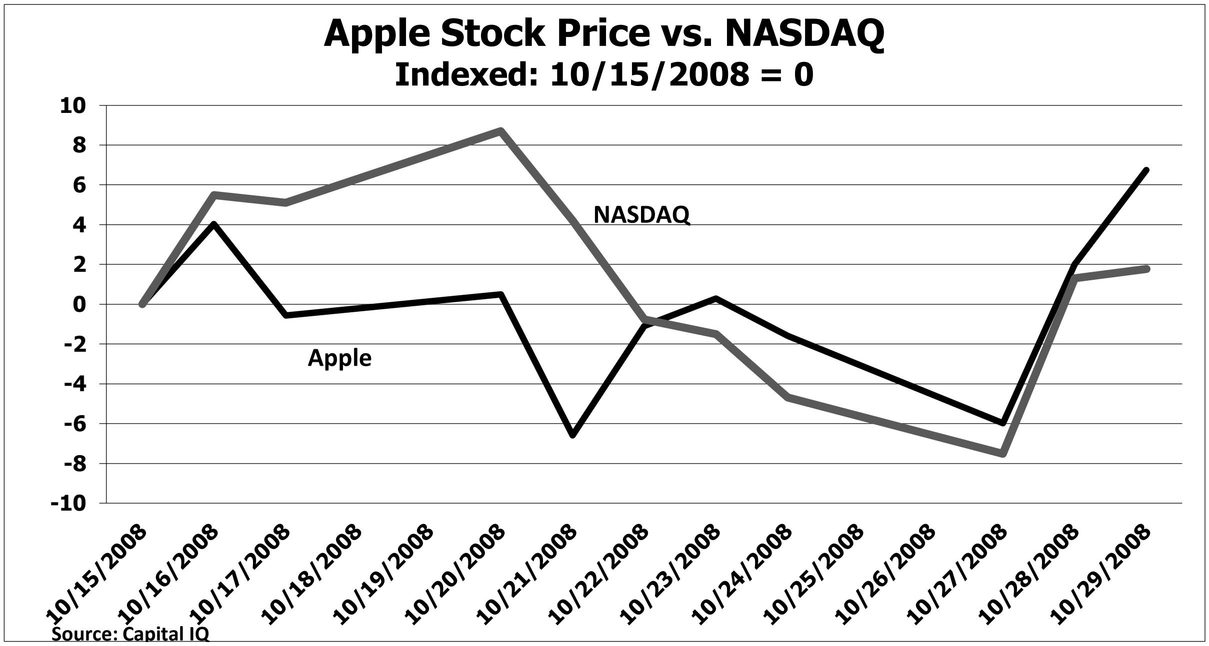
Management believes investors will benefit from greater transparency in referring to these non-GAAP financial measures when assessing the Company's operating results, as well as when forecasting and analyzing future periods. However, management recognizes that:

- these non-GAAP financial measures are limited in their usefulness and should be considered only as a supplement to the Company's GAAP financial measures;
- these non-GAAP financial measures should not be considered in isolation from, or as a substitute for, the Company's GAAP financial measures;
- these non-GAAP financial measures should not be considered to be superior to the Company's GAAP financial measures; and
- these non-GAAP financial measures were not prepared in accordance with GAAP and investors should not assume that the non-GAAP financial measures presented in this earnings release were prepared under a comprehensive set of rules or principles.

Further, these non-GAAP financial measures may be unique to the Company, as they may be different from non-GAAP financial measures used by other companies. As such, this presentation of non-GAAP financial measures may not enhance the comparability of the Company's results to the results of other companies.

Source: "Apple Reports Fourth Quarter Results," October 21, 2008, http://www.apple.com/pr/library/2008/10/21results.html, accessed February 8, 2011.

Exhibit 6 Apple Inc. Share Price Performance (October 15, 2008–October 29, 2008)



Note: Apple share price performance versus the Nasdaq Composite Index over the time period surrounding Apple's Q4 of FY 2008 earnings announcement on October 21, 2008, that included non-GAAP supplements.

Endnotes

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