

How Sour Is the Apple Inc.? What the Rest of the World Can Learn about Financial Reporting from Apple's Less Than Exemplary Role Modeling

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Abstract

While Apple Inc. steadily sets records in terms of market capitalization and innovation; the untold tale is how the company and its executives have evidenced less than exemplary ethics. This paper proceeds as a case study of Apple Inc. to see what ethical advances must be made in the financial reporting environment before this area can truly be considered ethical.

Key words: Apple; financial reporting; ethics; auditors; regulators; securities fraud.

Introduction

On January 23, 2013, with the announcement that the Company did not meet analysts' objectives for iPad and iPhone sales for the first quarter because of supply issues, Apple Inc.'s stock fell 12.36 percent, resulting in the loss of \$59.64 billion in market capitalization (1). Many just chalked it up to the bad quarter. Indeed, both investors and consumers love the company. Before and since this event, investors have earned extraordinary returns on Apple stock as the company continues to set records for largest market

capitalization in history. Further, consumers seem to care less about the ethics of the company so long as they receive the latest iPad or iPhone for Christmas. Lost in all the love is company executives' seemingly ever-present unethical financial reporting, culminating in the events that led to that almost record-setting stock market capitalization decline.

This article demonstrates Apple's unethical financial reporting for the world to judge whether the Apple way is the new normal or the final warning for those individuals interested in virtue ethics to begin intervening.

This article is the first in recent years to critique Apple's financial reporting as the company is viewed as otherwise untouchable. The article proceeds by analyzing whether Apple executives' financial reporting has been so unethical that it rises to the level of being securities fraud. Whether the reader agrees or not in the level of fraudulent reporting, this type of close examination provides greater evidence of the degree to which unethical reporting occurs.

Methodology

To prove securities fraud, plaintiff securities class action firms must show intentional or reckless materially false or misleading statements of or omissions of, facts resulting in reliance by investors, causing damages to those investors (2). The important elements are the level of intent, materiality, misstatement or omission, fact, damages, causation, and reliance (3). The only difficult element to demonstrate usually is the level of intent, direct knowledge of the fraudulent reporting in which the person is engaging or at least reckless disregard with regard to the truth of the reporting.

Discussion

Intent

On April 18, 2012, Qualcomm, Inc., Apple's 28-nanometer chip supplier for the iPhone 5, announced that it would have supply issues for *all* its clients through the end of the 2012 calendar year and extending into the start of 2013.

On October 25, 2012, Apple's Chief Executive Officer (CEO) announced that there would be no supply issues for the iPad and iPhone for the next quarter through January 23, 2013. But in January, Apple's CEO announced that there had, in fact, been supply issues for the iPad and iPhone that materially lowered sales during the quarter. These materially lowered sales caused the analysts' objective for iPad and iPhone sales to be missed.

Thus, Apple's CEO knew that he was misleading the public in reporting that there would be no supply issues. If Qualcomm, Inc., Apple's supplier notified financial analysts on April 18, 2012, that there would be supply issues, that supplier certainly also notified Apple of this fact at least by that date. Apple's CEO intentionally or at least recklessly misled the public with that announcement on October 25, 2012. Further, the CEO also intentionally or at least recklessly omitted announcing to the public as early as April 18, 2012 that there would be supply issues.

Materiality

As iPads and iPhones comprised most of Apple's annual sales, not having a sufficient supply to satisfy the projected demand was certainly significant enough to be material. In fact, Apple's yearly earnings guidance was based on the projected demand, which the executives knew

as early as April 2012, could not be satisfied with adequate supply given Qualcomm's issues.

Misstatement

The misstatement occurred during the October 25, 2012 public announcement that there would be *no* supply issues except possibly for the iMac.

iMac Supply Issues

While the CEO admitted to supply issues with regard to the iMacs in the final quarter of 2012, he did not modify the guidance for iMac sales for the first quarter of 2013. Later, he admitted that they had scrambled just to meet the guidance release date for the 21.5-inch screen in November, pushing it out just in time at the end of the month. The larger screen came out in December.

The CEO did convey on October 25, 2012, "In terms of general shortages, . . . the iMac will be constrained for the full quarter in [a] significant way. Part of that [situation] is that we're beginning shipping the 21.5-inch iMac in November and the 27-inch in December, so there will be [a] short amount of time during the quarter to manufacturer and ramp those [units]. . . I expect the demand to be robust, so we will have [a] significant shortage there" (4).

However, on January 23, 2013, an analyst indicated there was the \$1.5 billion shortfall on iMac sales for the quarter, which begged the question; why was prior diminished guidance not provided (5)?

The CEO responded with, “iMacs were down by 700,000 units year-over-year. . . . [We] announced the new iMacs late in October . . . and [that the] 21.5-inch would ship in November. [We] did ship it at the end of November. We announced that the 27-inch would ship in December, and we did ship them in mid-December. [Thus,] there were limited weeks of ramping on these products during the quarter. We left the quarter with significant constraints on the iMac, and we believe we know that our sales would have been materially higher if those constraints would not have [existed]. . . . The [other] part [is] that our channel inventory was down from the beginning of the quarter by over 100,000 units . . . because, obviously, we didn't have the iMacs and channel inventory was in significant constraint [emphasis added]” (6).

iPhone Supply Issues

Based on this conservative estimate history, the market expected 50 to 70 million iPhones to be sold in the first quarter of 2013, especially because the CEO had stated so confidently that there would be no supply issues. However, Apple fell below the 50 million mark for the quarter and had to lower its unit estimates for the next quarter and the year.

During the October 25, 2012, conference call, Apple's CEO stated, “In terms of . . . the iPhone, I don't see [any] component shortage for the quarter [We've] solved some challenges there and feel good about our position. . . . We [expect high] demand with the revenue guidance that [the Chief Financial Officer] talked about earlier [emphasis added]” (7).

During the January 23, 2013 conference call, the CEO stated, “If you look at the iPhone sales [for] the

quarter, we were very constrained for much of the quarter on iPhone 5. . . . iPhone 4 was actually in constraint for the entire quarter . . . [emphasis added]” (8).

iPad Supply Issues

During the October 25, 2012, conference call, Apple’s CEO stated, “In terms of the iPad . . . I don’t see [any] component shortage for the quarter [We’ve] solved some challenges there and feel good about our position. . . . We [expect high] demand with the revenue guidance that [the Chief Financial Officer] talked about earlier [emphasis added]” (9).

But, during the January 23, 2013 conference call, Apple’s Senior Vice President and Chief Financial Officer said, “With the iPad mini, it’s [difficult] to know. We could not make enough [iPad minis] in the quarter. We were constrained every week. . . . [We] wish that we could have made more, and we ended the quarter with significant backlog. . . . [We] expect to be able to meet demand for this product in the March quarter, which again we could not in the December quarter [emphasis added]” (10).

In the same call the CEO stated, “iPad mini was very constrained We believe that we can achieve supply-demand balance on iPad mini later this quarter” (11).

The CEO continued, “[Then] overall our team did just [a] fantastic job ramping out . . . products during the quarter. We did have significant shortages . . . on both iPad mini and both models of the iMac that [lasted] the entire quarter, and we are still short of both of those today Additionally, supply of iPhone 5 was short to demand . . . ,

and iPhone 4 was short We believe that we can achieve supply/demand balance on iPad mini during this quarter On iMac we're confident that we [will] . . . significantly increase the supply, but the demand tier is very strong. [Thus,] we're not certain that we will achieve supply demand balance during the quarter [emphasis added]" (12). With regard to this lack of supply, only the iMac had any cautionary comment made during the October 25, 2012 conference call.

Omission

The omission occurred April 18, 2012 (or around that time) when Apple failed to tell the public what it obviously knew about the Qualcomm supply shortages. Apple had to know at that time that there would be serious supply issues for its products, because of Qualcomm's declared shortages through the rest of the year and extending into 2013.

Recall, the CEO of Apple commented during the fourth quarter of 2012 conference call that there *would not* be any supply issues with regard to the iPhone. But, later, during the first quarter of 2013 conference call, he admitted that there *had indeed* been supply issues that had resulted in material losses in iPhone sales revenues.

Also, remember that during the October 25, 2012, conference call, Apple's CEO stated, "In terms of . . . iPhone, I don't see [any] component shortage for the quarter [We've] solved some challenges there and feel good about our position. . . . We [expect high] demand with the revenue guidance that [the Chief Financial Officer] talked about earlier [emphasis added]" (13).

Then during the January 23, 2013 conference call, the CEO admitted, “If you look at the iPhone sales [for] the quarter, we were very constrained for much of the quarter on iPhone 5. . . . iPhone 4 was actually in constraint for the entire quarter . . . [emphasis added]” (14).

Qualcomm, Inc. made the 28-nanometer chip for Apple’s iPhone 5 and other chips for the company (15). The CEO of Apple would have been put on notice about the short supply early as February 1, 2012, when Qualcomm, Inc. gave official notice to the market that there would be insufficient 28-nanometer supply to meet demand in the coming months. The President and COO of Qualcomm, Inc. remarked, “we are seeing strong OEM demand for [28-nanometer chips then] even above our prior expectations [emphasis added]” (16).

Certainly by the April 18, 2012 conference call, Apple’s CEO was officially notified that his chief supplier for the 28-nanometer chips for the iPhones, Qualcomm, Inc., would have insufficient supply to meet Apple’s demand through the end of 2012 and extending into 2013, as the Chairman and CEO of Qualcomm, Inc. disclosed: “We’re seeing very strong demand for our . . . 28-nanometer products. [There] is [a] shortage of 28-nanometer capacity, and at this stage we cannot secure enough supply to meet the increasing demand We’re working closely with our partners to bring additional capacity online. However, the constraints on 28-nanometer supply are limiting our potential [units of sales for] this fiscal year [emphasis added]” (17). The CEO of Apple had to know that its 28-nanometer supply for its iPhone 5 was in doubt at that point in time because in response to an analyst’s comment on that call, “some of your customers are worried about your ability to supply given the demand is greater than the ability to supply,” the President and

Chief Operating Officer (COO) of Qualcomm, Inc. stated “[Qualcomm, Inc.’s] approach [is] to spread the supply [proportionately to] all . . . the customers” (18).

The Chairman and CEO of Qualcomm, Inc. further shared, “[We] expect to be supply constrained through the fiscal year. [We’re] looking to the December quarter to see [the first] significant improvement in supply [emphasis added]” (19).

The Executive Vice President and Chief Financial Officer of Qualcomm, Inc. further reinforced that the Company did not expect to be able to finish the fiscal year with supply and demand in balance and actually disclosed that the issue would continue through their reporting on January 30, 2013 (20).

The President and COO of Qualcomm, Inc. confirmed that it would be “years” before the supply and demand for the 28-nanometer come in to balance (21).

On the July 18, 2012, Qualcomm, Inc. conference call, the Chairman and CEO of Qualcomm, Inc. reiterated: “[Qualcomm, Inc. is] continuing [to see] the strong demand for our . . . 28-nanometer chips, and that demand continues to [be then greater than] our available supply. We will continue to ramp capacity in the upcoming quarters consistent with prior expectation, [but] the constraint on 28-nanometer supply [is] continuing to limit potential [unit sales] this fiscal year [emphasis added]” (22).

The President and COO also confirmed, “We continue to be supplies constrained on our 28-nanometer products but are ramping supply with multiple foundries in the September quarter and again into the December quarter consistent with our prior expectations. We currently project

that we will be able to closely match supply with demand [at the end of] the calendar year [emphasis added]" (23).

He continued, "The supply really [leaves] the [December] quarter [in the] match situation. [It] doesn't enter the quarter that way. [At] the beginning of the quarter, we still have the [shortfall] that . . . we have to deal with, but it improves throughout the quarter. We [expect] it matches up toward the end" (24).

During the November 7, 2012, Qualcomm, Inc. conference call, the President and COO reasserted, "we remain on track to match our current 28 nanometer demand profile [leaving] the December quarter [emphasis added]." (25)

He continued, "For the fourth quarter, we have been talking about how we thought that [leaving] the fourth quarter we thought supply and demand of 28 nanometer would be matched. By implication the starting point or the beginning part of the quarter meaning . . . October [We] are still . . . not enough supply. . . . Now, [entering] March, we feel that we have supply and demand in balance . . . [emphasis added]" (26).

Apple's CEO was asked the following question on April 24, 2012: "There's talk about potential Qualcomm shortages into the next couple of quarters and potential constraints even at year-end for some pretty neat products that it might be good for you to have and some product down the road. I know you don't comment on future products, but this is a big concern, and I guess, can you just talk directionally about whether you expect long-term to get more than your fair share of product and what you need and do you see any bottlenecks on the horizon that are

major in that department or in any component down the line over the long term? (27)”

He responded: “Tough question to answer Obviously, we are aware of the lithography transition issue that you mentioned with 28-nanometer. . . . [We] don’t comment [on these issues]. Generally, . . . we work very closely with our supplier partners and do everything that we can do to get supply, and sometimes we are successful with that and sometimes we are not. [Thus,] you can bet that we are [considering] anything that we think [could] impact us in trying to push every button [at] our disposal to work on it” (28).

The same question reappeared on the July 18, 2012 conference call. “[For the] component availability, particularly new components?” (29).

The CEO responded, “We factored supplying to the guidance that . . . has [been] given [to] you. Generally, I should say that we have been short of the Mac We ended the quarter with backlog, and we’re working . . . to deliver those to customers quickly. [We] believe that we’ll be in supply demand balance in August. In terms of . . . [other] products, I obviously don’t talk about [them or] the parts that are in them [If] we’re short of something, you can bet that we will be spending our energies on . . . that [situation]” (30).

During the October 25, 2012 conference call, the Apple CEO was asked what effect the supply constraints had on cost of goods sold. The CEO did not admit to any supply constraints but just discussed ramping (31).

Fact

The facts concerning whether the company would have adequate supply of inputs to produce to the extent of expected output demand are all in question.

Damages

As previously discussed, on January 23, 2013, Apple Inc.'s stock fell 12.36 percent, resulting in the loss of \$59.64 billion in market capitalization.

Causation

The stock declined on that date when the public learned that the previously indicated sufficient supplies of inputs for the iPad and iPhone were in fact insufficient.

Reliance

The public had relied on the reassurances during the previous quarter that there would be no supply issues. After all, if the public had believed otherwise at that point, the stock would have fallen by roughly the same amount back in October of 2012, not in January 2013. The efficient market hypothesis and even the semi-efficient market hypothesis support this reasoning.

Other Evidence of Securities Fraud Intent

Apple Inc.'s executives also misled or omitted other less material issues. For instance, during the previous October 25, 2012, quarterly announcement, they stated that the reasons for declining margins on Apple products were certainly not increased competition and desire to reduce

prices to stabilize market share, which in fact were the reasons for those declining margins. Also, the executives remarked that new Apple products generally have lower margins, which was untrue over time. Finally, after years of earnings guidance procedures designed to permit the stock to pop upward on earnings announcement “surprises,” the executives admitted to intentionally misrepresenting the company’s true internal numbers. Insider selling elevates the level of intent as it shows that executives could profit off these unethical disclosures.

Margins in General.

Apple’s iPhone margins had been declining, though, not during the first quarter of 2013. After learning of Apple’s diminished margin guidance for September, an analyst stated, “I want to better understand the gross margin guidance for September, given that [it has] been nearly two years since you’ve operated at . . . sub 40% gross margin” (32). Increased competition was the reason. Apple’s January 23, 2013 stock price decline was in part because of “disappointing holiday-period iPhone sales [reinforcing] fears it is losing its dominance in smartphones” (33). However, the officers and directors refused to admit to the loss of market share. They even refused to disclose that their internal objective had in fact been to keep market share.

On January 23, 2013, the CEO indicated to the public, “[We] aren’t interested in revenue [just for market share purposes]” (34). According to the CEO (July 24, 2012 conference call) innovating products was the objective, not increasing market share (35), “On the iPhone, we continue to be [thrilled] with the moves that we made in [lowering] pricing [and therein the margins] . . . [contributing] to our ability to achieve \$35 million in sales

which is our second highest quarter of all times” (36). Even the Senior Vice President and Chief Financial Officer remarked (October 25, 2012) “we lowered the price of the iPhone 4S and iPhone 4 delivering incredible value to our customers” (37). Apple’s officers and directors lowered the price not to deliver value but instead to remain competitive with their offerings and keep market share. The CEO stated that “this relentless commitment to innovation and excellence is the reason that our customers choose to buy our products, and this will always be the driving force behind Apple” (38). But, if innovation is why customers buy the products, then Apple would not have to reduce the prices to be competitive with other similar products.

New Product Margins

The officers and directors repeatedly stated that new Apple products tended to have lower margins. But, an analyst challenged them, “[The] Company’s price premium or supply chain advantage is weakening [because of the lower margins]” (39).

The Senior Vice President and Chief Financial Officer responded, “The iPhone 5, iPad Mini, iMac, MacBook Pro 13-inch, iPod Touch and iPod Nano . . . have higher cost than their predecessors and therefore lower gross margins as they are at the height of the cost curve. This has been the case with new products in the past, so nothing new. The difference this time is the sheer number of new products we are introducing in [a] very short period of time” (40).

That statement was completely false and misleading in a material extent. Apple’s most innovative products over time had larger margins because of pricing power. Apple consistently had been first to market and therefore had

market pricing power, creating the larger margins. If there is pricing power, the cost is irrelevant and can be passed on to the consumer.

An analyst shared this background during the October 25, 2012, conference call, “[Given] what we’re seeing in margins as some of these products get more expensive to produce to be competitive, would you be open to passing some of those costs onto your customers because obviously historically you’ve . . . announced new products and maintained [much] of those price points?” (41). The lack of innovation in the current generation of iPhones led to decreased pricing power and market share (42). The Senior Vice President and Chief Financial Officer contradicted his own earlier statement, emphasizing, “margins on new products are lower than their predecessors” (43).

Guidance Procedures

Because the Company’s officers and directors knew that Apple was entering a period of declining numbers, they initiated new guidance procedures on January 23, 2013. Instead of providing conservative point numbers, underestimating the true internal number by 35 percent or more, they would now provide *ranges* of likely revenues and margins. However, the officers and directors would not provide any guidance for earnings per share.

Truly, this change in guidance should have caused the extreme market reaction in and of itself. Indeed, this change admitted to the market that, for years, Apple intentionally understated guidance estimates below internal expectations of the actual number. While the market could have assumed that fact over time, Apple finally directly acknowledged it. Its officers and directors committed fraud

on the market for years. The objective was to surprise the market to the up side in each quarter, resulting in larger stock price increases on those earnings announcements.

According to the Senior Vice President and Chief Financial Officer (January 23, 2013), “In recent years, our guidance reflected [a] conservative point estimate of results every quarter that we had reasonable confidence in achieving. [We now] plan to provide [a] range of guidance that [reflects] our belief of what we are likely to achieve. While we cannot forecast with complete accuracy, we believe we are likely to report within the range of guidance we provide. Therefore, for the March quarter, we're providing revenue guidance of between \$41 billion and \$43 billion compared to \$39.2 billion in the year ago quarter” (44).

An analyst's question during the January 23, 2013 conference call was, “Are you effectively saying that [your previous guidance procedure] was uniquely conservative and that level of conservatism no longer exists? We're actually getting the real planning range for Apple and that this [guidance] is fundamentally different from how you approached and provided guidance?” (45).

The Senior Vice President and Chief Financial Officer responded, “In the past we provided [a] single-point estimate of guidance that was conservative, that we had reasonable confidence in achieving. This quarter and [in future quarters then] we[will] provide [a] range of guidance that we believe that we're likely to report within. . . . [We] believe that we will report within that range” (46).

The analyst's questioning continued, “[your conservative point estimate meant] on average . . . clips to your guidance on EPS by 35% . . . something that you felt

reasonably confident in achieving. Was there an implicit [margin of safety] in there because I'm trying to reconcile the fact that you said you thought it was reasonable before, [however,] your historical precedent was you eclipsed it enormously on [a consistent] basis, and this time you're saying there is [the] likelihood of falling within the range...?" (47).

The Senior Vice President and Chief Financial Officer responded, "In the past, we gave you [a] single-point estimate of guidance that was conservative, and we had as reasonable confidence as you can, that we would achieve. We're now providing you [with a] range of guidance that we expect we can report within [in future quarters]" (48).

Another analyst questioned the lack of earnings per share guidance, "[Apple provided] gross margin guidance this quarter but no [earnings per share] guidance. Are there any moving parts between the gross margin and the operating line that we should be aware of that might have account nuances in how you're giving guidance?" (49).

The Senior Vice President and Chief Financial Officer responded, "Our prior method of providing guidance was [a] point estimate for each line item of the [income statement], including [earnings per share]. [Our] guidance for the March quarter and how we will give guidance in the future, we [will] . . . give [a] range for revenue, for gross margin, and for [operating expenses]. [Thus,] there are many possibilities for [earnings per share in] the range that we'll leave you to [develop]. [We'll] report our actual results for March to you in April" (50).

Insider Selling

Qualcomm, Inc. likely notified Apple Inc. of supply issues as early as March 2012, when Qualcomm, Inc. first learned of demand beyond expectations for its 28-nanometer chip production capacity, which was a critical component to Apple's iPhone 5 that was to be released later in that calendar year. Interestingly, significant Apple insider trading began at this same time. For instance, the CEO sold 20,000 shares on March 12, 2012. Then, more significantly, the CEO sold 100,000 shares on March 26, 2012. On the same date, the Senior Vice President and Chief Financial Officer sold 79,000 shares. Another Senior Vice President also sold 65,000 shares on that same date. And, another Apple Senior Vice President sold 4,000 shares just before Qualcomm, Inc.'s announcement of supply issues to the public.

After the Qualcomm, Inc. public announcement of supply issues, yet another Apple Senior Vice President sold 60,000 shares and an important director sold 40,000 shares on April 27, 2012. One week later another director sold 7,500 shares. Simultaneously, the Vice President and Corporate Controller sold almost 3,000 shares. Another Senior Vice President sold 10,000 shares on July 30, 2012. In early August the director who had previously sold 7,500 shares, sold 7,500 more shares. In late August, the director who had previously sold 40,000 shares sold an additional 25,000 more shares. Another Senior Vice President sold 3,400 shares in late September. Another Senior Vice President sold 4,000 shares just before Apple's 2012 year end report. In November, another Senior Vice President sold 10,000 shares, and another director sold 7,500 shares. In the middle of November, another Senior Vice President sold 20,000 shares. At the end of November two new Senior Vice Presidents sold 35,000 and 15,000 shares.

In total, Apple executives sold 268,000 shares after Qualcomm's February 1st 2012 public announcement of their expected short fall in production capacity for 28-nanometer chips. An additional 247,900 shares were sold between April and November 2012.

Implications

Auditors must be required to also review and report on quarterly and annual announcements and the oral question and answer presentations. The question and answer presentations on whether expected earnings have been met are more important to market fluctuations than the financial data underlying this information, which the auditors already review or audit.

Government securities enforcement agencies must also emphasize reviewing the quarterly and annual announcements and the all oral question and answer presentations. If separate divisions are created to enforce the disclosures in these presentations, then that approach must be pursued.

While important companies should be considered the same as every other company and treated the same, providing an example to the rest of the companies by pursuing top companies like Apple would have a greater deterring effect on such unethical reporting.

Those individuals who still believe in virtue ethics must emphasize that the best companies should lead by example and be the most compliant in their ethical financial reporting, not the least compliant. For better or worse, Apple is the role model for other businesses and to the

public for what a global business should represent. Their executives must set the example of good ethical leadership.

Conclusion

Ethics are perhaps more important in the financial reporting area than in any other. Huge damages can occur otherwise. Apple provides an important case study in the limitations of current financial reporting ethics. At a minimum this case study can provide the basis for a conversation to initiate better financial reporting ethics. Auditors, regulators, governments, and individuals can then implement the necessary ethical changes.

End Notes

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