October 21, 2010

Submitted via email (director@fasb.org)

Technical Director
Financial Accounting Standards Board
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Re: File Reference: No. 1820-100, Exposure Draft: Revenue from Contracts with Customers ED/2010/6, Revenue from Contracts with Customers

Apple Inc. (“Apple” or “the Company”) appreciates the opportunity to comment on the Financial Accounting Standards Board’s (“FASB” or “the Board”) exposure draft of a Proposed Accounting Standards Update Revenue from Contracts with Customers, issued June 24, 2010 (“the ED”). We support the FASB’s efforts of simplification and international convergence of revenue accounting and acknowledge the effort on the Board’s part to develop the ED. However, we believe in a number of areas the ED should be modified to allow for a more principles-based approach and avoid unnecessary and costly changes to existing accounting and disclosure requirements that will provide limited value to users of our financial statements. Specifically, we propose that:

- The current guidance on the accounting for product warranties should be retained;
- The guidance provided in the ED on identifying distinct performance obligations should be refined to ensure that the concept of a distinct profit margin does not unnecessarily prevent the identification of distinct performance obligations;
- A broader more principle-based approach to the measurement of transaction price should be taken, and the requirement to use the probability-weighted amount should be eliminated;
- Prospective application upon the date of adoption should be allowed; and
- Certain disclosures required in the ED should be eliminated because they will not help users of financial statements understand the amount, timing and uncertainty of revenue and cash flow from contracts with customers.

Our views on these matters are explained in more detail in the following paragraphs.
THE CURRENT GUIDANCE FOR ACCOUNTING FOR PRODUCT WARRANTIES SHOULD BE RETAINED.

The ED requires that an entity should distinguish between product warranties that provide a customer with coverage for latent defects in the product and product warranties that provide a customer with coverage for faults that arise after the product is transferred to the customer. We do not agree with the approach in the ED. Currently, companies generally do not differentiate between these two types of warranties; instead companies distinguish between product warranties that are incurred in conjunction with the sale of another product versus those warranties sold separately. We believe the current approach is more appropriate.

Many companies include a standard warranty with the sale of their products that guarantees they will function according to specifications for a fixed time period. We believe that such standard warranties do not provide customers with an asset beyond the product to which it is attached and that is more appropriate to consider a standard warranty as a component of the delivered product or service. Fundamentally, a standard warranty that guarantees the product will function as specified at the time of sale is a cost of that sale. Therefore, we believe the approach in the ED for standard warranties does not accurately reflect the economic substance of the underlying transaction. If a company sells a warranty separately, we believe it is more appropriate to consider that type of warranty a separate performance obligation consistent with existing guidance in ASC 605-20.

Currently, standard warranties are accounted for as contingent costs under ASC 450. Separately priced extended warranties not included in the original price of the product covered by the warranty arrangement are accounted for under ASC 605-20-25 at their contract price with related revenue typically recognized over the contract period. The current accounting for these two types of warranties is relatively straightforward and practical, well understood by users of financial statements, reasonably represents the economic substance of both warranty types and offers financial statement users with relevant decision-useful information regarding the nature, cost and timing of warranty expense and related cash outflows. We do not see an issue with the current accounting that requires correction.

However, should the Board choose to retain the approach to warranty accounting proposed in the ED, we would be very concerned about the implementation guidance addressing how a company should account for products that include a warranty for latent defects. Specifically, the implementation guidance states at IG 14 and IG 15:

"... at the reporting date the entity shall determine the likelihood and extent of defective products that it has sold to customers and, hence, the amount of unsatisfied performance obligations to transfer those products.

Consequently, if the entity would be required to replace defective products, it does not recognize any revenue for those defective products when it transfers them to customers. If the entity would be required to repair defective products, it does not recognize revenue for the portion of the transaction price attributed to the products’ components expected to be replaced in the repair process."

The theory put forth in the ED supporting this proposed accounting is that a warranty with the objective of providing a customer with coverage for latent defects does not give rise to a separate performance obligation. Instead, such a warranty implies that for those specific products expected to experience failures of some kind, a company’s obligation to deliver a product that functions
perfectly over the life of the warranty has not been met. Therefore, some or all of the revenue from the sale of the covered product should be deferred. As described more directly in Example 4 in the ED, a company should only recognize all of the transaction price as revenue when customers obtain control of products without expected defects. Generally, we view this theory as flawed. In our experience most tangible products that experience failures covered by a warranty for latent defects fail some time after having been placed in service by the customer. In the meantime, a customer enjoys the full control, use and benefit of the product, including the benefit of those components that ultimately fail. We do not believe it is appropriate to defer some or all of the revenue under such circumstances. As described above, we believe a standard warranty that guarantees the product will function as specified at the time of sale is a cost of that sale.

Exactly how revenue is to be allocated to potentially hundreds or thousands of individual components of a product as required by the ED is unclear to us. Further, the ED provides no guidance regarding how the notion of “components” would be applied to intangible products like software. We are also concerned that this proposed accounting may require companies, including Apple, to develop complex new accounting systems and processes in order to track revenue deferrals and repairs for specific products and their individual components from their point of sale to their point of repair.

The implementation guidance requires that if a company “is required to replace defective products, it does not recognize any revenue for those defective products.” The FASB Staff has indicated to us that they believe this requirement to defer all revenue applies whether a company is contractually required to replace a defective product or merely chooses to do so for the sake of convenience and efficiency. We believe this proposed accounting further highlights the deficiency in the proposed approach to warranty accounting. Despite the fact a company may be required or choose to replace a defective product, regardless of how minor the latent defect is to the overall product, the fact remains the customer will often have the full use and benefit of the product during virtually the entire warranty period. Deferring all related revenue and product costs during some or all of warranty period does not reflect the true underlying economics of the sales transaction and supports the more appropriate view that standard warranties should be accounted for as costs of the sale of the product. Additionally, companies often make the choice to replace products that experience failures because it is cheaper and more convenient to replace a product immediately rather than repair a particular unit for a particular customer. We do not support an accounting model that proposes a radically different accounting outcome for product warranties simply because a company rationally chooses the most economically efficient way to satisfy its warranty obligation.

If the Board decides to discard the current approach for warranty accounting, we believe a better alternative to that proposed in the ED is to consider a standard warranty a separate performance obligation. We still believe the current approach to warranty accounting that considers a standard warranty to be a cost of sale to be preferable. However, treating a standard warranty as a performance obligation would be more appropriate than considering the warranty to be inseparable from the obligation to transfer the product. Treating a standard warranty as a separate performance obligation would result in the company estimating the selling price of such an obligation and deferring that amount each time a product with an attached warranty is sold. The deferral would be amortized over the term of the warranty obligation rather than being fully released as expected failures are actually corrected. For most companies, this approach would be less complex to implement than the proposed model that focuses more on individual units and their components, would better reflect the economics of a product warranties, would align the accounting approach for standard warranties with the approach used for separately priced extended warranties, and would completely avoid the scenario described above in which all of the
transaction price and related costs of sale are deferred when a company is required or chooses to fully replace a defective product.

In summary, we believe that the proposed accounting for product warranties in the ED will create serious and unnecessary practice issues, will be complex and expensive for many companies to implement and maintain, and provide little or no benefit to financial statement users who currently have a thorough understanding of the existing accounting requirements for product warranties. We urge the Board to reconsider retaining the existing guidance.

**THE GUIDANCE PROVIDED IN THE ED ON IDENTIFYING DISTINCT PERFORMANCE OBLIGATIONS SHOULD BE REFINED TO ENSURE THAT THE USE OF THE CONCEPT OF A DISTINCT PROFIT MARGIN DOES NOT UNNECESSARILY RESTRICT THE IDENTIFICATION OF DISTINCT PERFORMANCE OBLIGATIONS.**

We support the concept contained in the ED that for performance obligations to be identified and accounted for separately the promised good or service must be distinct. The first criterion in paragraph 23 of the ED provides that a good or service is considered distinct if the company, or another company, sells an identical or similar item separately. This basic principle is appropriate and should be relatively straightforward to apply in practice.

The second independent criteria in paragraph 23 states that a good or service is considered distinct if the company could sell the good or service separately because the good or service has both a distinct function and has a distinct profit margin. The concept of a distinct function is comparable to existing guidance in ASC 605-25. However, the concept of a distinct profit margin does not exist in current guidance, and we are concerned that the description of a distinct profit margin in paragraph 23 will in some cases result in inappropriately preventing the identification of a separate performance obligations.

In the absence of an observable selling price, the ED appears to advance the conclusion that a company would only be able to estimate a selling price of a good or service if it can identify the distinguishable resources needed to provide the good or service. This conclusion appears to assume that all actual selling prices are based on the costs of distinguishable resources and that all estimated selling prices should be based on such costs as well. It also assumes the same resources could never produce multiple products or provide multiple services. In fact, the selling prices of many products, especially certain intangibles, are often not based on cost. For example, in the guidance already issued by several large public accounting firms addressing the ED, the firms have suggested that certain intangibles not regularly sold on a standalone basis, such as software always bundled with post-contract support ("PCS"), may have to be combined into a single performance obligation. This is because the same resources may be used to create the software as are used to provide the PCS. Identification of separate and distinct resources or costs should not be required in order to identify and account for performance obligations separately because a single set resources can, and often do, deliver distinct performance obligations. Intangibles, including software and certain types of related PCS, that are sold separately often have very high margins, so related costs are not the primary consideration when actual pricing is established. In this example, the proposed accounting for the software and the PCS as one performance obligation would not reflect the economic substance of the transaction. It is likely this same conclusion will be reached for other transactions involving intangibles when applying the guidance in the ED.
A more appropriate principle is a good or service would be considered to have a distinct profit margin if the company has a reasonable basis in estimating the margin if it were sold on a standalone basis. A reasonable basis for such an estimate may often focus on the distinct costs a company expects to incur in providing the good or service. However, in circumstances when costs are not the primary focus in determining pricing, such as the sale of many intangibles, a reasonable basis for such an estimate could be supported by a company’s own experience or by the observable experience of other entities with similar products in similar markets. This would be consistent with existing guidance in ASC 605-25 that requires a company to estimate a selling price for deliverables for which VSOE or third-party evidence of selling price does not exist. Such an approach more appropriately identifies and accounts for the distinct performance obligations in an arrangement in accordance with the intended principles-based approach of the ED.

A Broader More Principles-Based Approach to the Measurement of Transaction Price Should be Taken, and the Requirement to Use the Probability-Weighted Amount Should be Eliminated.

The ED generally requires companies to use the probability-weighted estimate of consideration that a company expects to receive to measure the transaction price. For several reasons we believe this requirement should be removed, and companies should be allowed to use management’s best estimate of transaction price. Strict application of the probability-weighted estimates will often result in estimates that are not possible outcomes and are not actually expected by management to occur. Use of probability-weighted estimates will also falsely imply to financial statement users a level of mathematical precision that would in fact be based on the same exercise of management judgment as would be applied in determining management’s best estimate. We have heard the argument put forth that use of probability-weighted estimates to measure transaction price would often result in outcomes similar to use of management’s best estimates. We find this position unconvincing because even if true in some cases, the time and expense of developing probability-weighted estimates, including the necessary internal controls, would provide no return benefit.

We believe that the use of management’s best estimate is the most useful measure of the performance obligations in a contract. This approach would allow for the exercise of appropriate management judgment to determine the transaction price, rather than estimating multiple outcomes and applying arbitrary probabilities to those outcomes. Use of management’s best estimate provides the most decision useful information for investors, as it would reflect the most likely transaction price expected to be received rather than a range of possible outcomes or a statistically based average with potentially little relevance to the underlying transaction.

Prospective Application Upon the Date of Adoption Should be Allowed

For many companies, retrospective application of the ED will be expensive and burdensome. Retrospective application would require such preparers to develop and maintain dual reporting systems under both current GAAP and the proposed model for the retrospective period. Retrospective application under these circumstances will require companies to invest heavily in systems and personnel, and the exceptions in ASC 250 define only limited situations when it would be appropriate to conclude retrospective application is impractical to perform. Further, we are concerned that the impact on systems and other resources will be magnified by the overlapping requirements to adopt several proposed convergence ASUs over the same time frame.
To address these concerns, we recommend that the Boards implement a transition alternative similar to that allowed in Update No. 2009-13 Revenue Recognition (Topic 605): Multiple-Deliverable Revenue Arrangements and Update No. 2009-14 Software (Topic 985): Certain Revenue Arrangements That Include Software Elements. This transition alternative would allow prospective application upon the date of adoption with the requirement to disclose comparative information for either the period of change or the period immediately preceding the change. Retrospective application would also be permitted. We believe that disclosing at least one period of comparative information about the change in accounting for revenue recognition provides sufficient information to financial statement users about how the change affects a particular company. Additionally, our proposed transition approach would give companies substantially more time to prepare their systems and personnel for the transition to the new accounting requirements.

**CERTAIN DISCLOSURES REQUIRED IN THE ED SHOULD BE ELIMINATED BECAUSE THEY WILL NOT HELP USERS OF FINANCIAL STATEMENTS UNDERSTAND THE AMOUNT, TIMING AND UNCERTAINTY OF REVENUE AND CASH FLOW FROM CONTRACTS WITH CUSTOMERS.**

The disclosures required in the ED are substantially more extensive than those required by current U.S. GAAP. We believe that certain of these proposed disclosures do not provide decision-useful information to financial statement users. In particular, the requirement to disclose the reconciliation of contract balances and reconciliation of onerous performance obligations and the requirement to disclose the total amount of performance obligations and the expected timing of their satisfaction will not help users understand the amount, timing and uncertainty of revenue and cash flows. Few, if any, companies currently have the complex systems in place required to generate the information necessary to support these proposed disclosure requirements. The negligible benefit of these reconciliations does not outweigh the cost of providing them. Further, there is already a concern that current financial statement disclosures are complex and excessive, and we believe these proposed disclosures in the ED will unnecessarily add to the complexity.

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We have registered and plan on participating in the round table sessions for the ED in October. Please contact me at (408) 862-1401 if you have any questions regarding our response or other aspects of the ED.

Very truly yours,

Betsy Rafael
Vice President, Corporate Controller
and Principal Accounting Officer