



### **Apple's iPhone Upgrade Program; an Innovative Approach at Configuring an Extended-Service Offering**

Recently Apple introduced the "Apple iPhone Upgrade Program" (note only applicable in the US, and the connection to a wireless network is not included). A review of the program indicates it is an extended-service offering, with a twist, that may become a precursor to a new business model embraced by many enterprises.

Traditionally, an extended-service offering is "attached", as a separate fixed-fee transaction, concurrent with the sale transaction of a product.

As for the iPhone program, the product is sold under an installment loan, combined with a portfolio of extended-services attached to the installment loan, for one fixed-fee per month. The program provides the buyer with access to a phone, as well as the assurance of maintaining the employability and "leading-edge" capabilities of the iPhone.

For the buyer, their value proposition is the following:

- Predictable cash outflow via a fixed-fee per month for a 2-year contract, with a 1-year extension after each year of use (e.g. sign initial contract effective 1/17 through 1/19, but on 1/18, the contract can be extended through 1/20).
- iPhone ownership.
- On an annual basis, is able to swap/exchange their iPhone that they have employed for the past year, for a never-employed iPhone that provides leading-edge technology/capability. This is a repeatable activity on a yearly basis for contracts that are in effect.
- Assurance that if the iPhone becomes unusable, due to a quality issue, the situation will be corrected, in a timely manner, for an unlimited number of events, as long as the contract is in effect. Employs AppleCare+ program.

- Assurance that if the iPhone becomes unusable, due to damage, the situation will be corrected, in a timely manner, for a limited number of events, as long as the contract is in effect. Employs AppleCare+ program. Note that this solution can be viewed as "insurance" by some regulators.

For Apple, their value proposition is the following:

- Recurring revenue from the initial contract and its extensions
- Recurring demand for iPhones supplied from their manufacturing operations
- A supply source for "trailing edge" iPhones that have been swapped/exchanged and inducted into a refurbishment process. They are then sold in secondary markets at price points lower than that of the "leading edge" iPhones, creating a new market for the iPhone, as well as future customers for their leading edge phones

### Insights

For commercial buyers, the phone could be accounted as a Capital Expense [CapEx], especially if large quantities are purchased, or accounted as an Operating Expense [OpEx] that is applied as a period expenditure. At a unit value of \$700, large enterprises could have \$millions of investment in the iPhone reported on their balance sheet, if reported as a CapEx, or the units could be "asset ghosts", if reported as an OpEx.

In conclusion I believe that the construct of Apple's iPhone Upgrade Program may be quite viable for many products. For commercial machines, the swap/exchange for leading-edge technology/capabilities would not necessarily be for the entire machine, but for a component and/or embedded software. It will be interesting in the next few years to observe how business models will evolve in the extended-services marketplace.

Note that a new FASB rule in effect 1/19 requires that ALL assets engaged under an operating lease MUST be identified and reflected upon the lessee's balance sheet as a liability. As a result auditors will need to be assured that all fixed assets accessed under an operating lease are properly accounted for, which will in turn require that all assets, those owned and those leased, be reported. I believe that this new ruling will go a long way at addressing the "mess" discussed in your post.

Sam:

This Apple program is a portfolio of services; some extended-services and other not extended services. I would call it a fixed-fee for a portfolio of services to assure the phone's employability and delivering the user with an experience of the most current level of hardware and software capabilities.

24-month installment loan that bundles the phone purchase, services of the AppleCare+ program and an upgrade exchange/swap

- Phone ownership
- Upon 12 monthly payment, buyer is eligible to exchange/swap their phone for a phone with the most current configuration/technology
- Upon upgrade, loan is reset back to a 24 months of payments, with the same monthly payment amount
- Legacy AppleCare+
  - Unlimited corrective services due to quality issues under the AppleCare+ program (e.g. phone user's camera is fixed if it fails)
  - limited corrective services due to damage (e.g. user's phone is dropped, screen shatters and screen replaced; limited to 2 occurrences during contract period)

Upgrade

- like-kind exchange to obtain the most current iPhone model's capabilities (e.g. user has latest & greatest configuration of the phone model being delivered from the production line)

Why is the above program not a "pure" PaaS:

- First and foremost, the buyer must purchase the phone; this is a legacy sale transaction, not a service

Apple chose specific products and services to fulfill the above solutions; though they were not the only choices that were available to them. This post will provide insights as to Apple's choices, as well as the alternatives that they could have chosen.

The lesson learned of this post is to enlighten the reader as to the many configurations that are available for delivering a PaaS solution; each impacting the seller and buyer in different ways.

**Apple's Choice to provide access to an iPhone:**

Apple offers 24-month, 0% APR installment loan for the purchase/sale of the phone; buyer "owns" phone.

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Apple probably classifies new condition iPhone as inventory, current asset, on the balance sheet of their Apple store.

How would Apple financially account for an iPhone if offered by Apple as an operating lease or rental. Apple, or a third-party financial service party would own the phone, with the iPhone's adjusted asset value reflected on the owner's balance sheet.

Profit margins are often higher for leases/rentals versus a sale, due to the risks of ownership have been transferred from that of the operator to that of the lessor/renter. Total Ownership Cost [TOC] is typically higher, but counterbalanced with less risk of unfavorable asset devaluation

For commercial buyers, a new FASB ruling would require the iPhone to be reflected as a liability on their balance sheet equal to its depreciation value during the life of the operating lease. Also the units would be required to be tracked to meet FASB's new ruling

Rentals are not reflected on the buyer's balance sheet under new FASB ruling.

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- Apple recognizes revenue of the sale price at the time the user obtains access to the phone.
- **Impact on Buyer**
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**Alternative Choices to provide access to an iPhone;  
2-year operating lease or 1-year rental with 1-year renewal:**

- **Impact on Apple:**
- (AppleCare+)
- **Impact on Buyer**

**Apple's Choice to provide** unlimited corrections of a unit's failure (AppleCare+) due to quality issues

- Advanced capabilities: trade-in eligible every 12 months for latest-and-greatest iPhone version, but the 12 months remaining on 0% APR installment loan is re-set to a 24 month period
  - Note that

1-"Trade-in" phone yearly: like-kind exchange transaction service (sales taxes paid on the difference in value between old phone and new phone); tax payments most likely rolled-up in fixed monthly fee. Like buying a 2016 Jaguar and trading-in a 2011 Jaguar; pay sales taxes on difference between the value of the two. This is NOT part of an extended-service.

Another way that Apple may be accounting for this trade-in is as a one-year "rental" service and NOT as an operating lease. Lots of GAAP issues. Neither is this part of an extended-service solution.

2-Software upgrade services between annual period of trade-in; that would be covered as an extended-service

3-Delivery of solutions to correct routine product failure (e.g. recall due to quality issue); that would be covered as an extended-service

4-AppleCare: insurance for correcting 2 events of non-routine damage (e.g. phone drop in toilet); this is NOT considered an extended-service but is defined for legal purposes as "insurance" Very important issue in the B2C world, but less in B2B.

The lesson to be learned is that there can be many paths to strategically and tactically deliver a PaaS; what is important