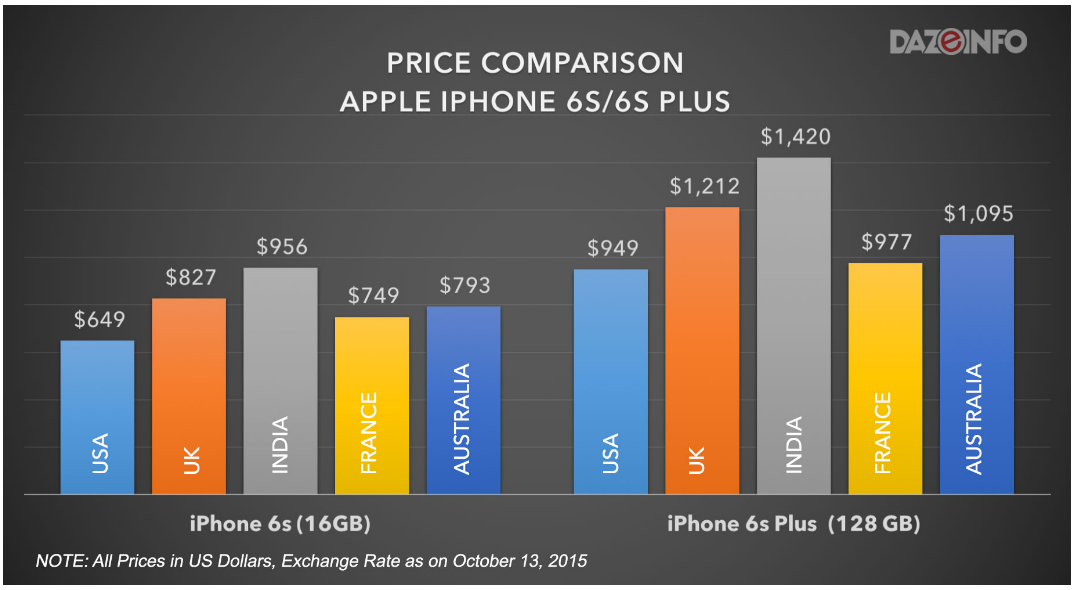
Tim Cook, CEO, Apple says, "... there are cost breakdowns that come out for our products that are much different than the reality. I've never seen one that is anywhere close to being accurate."

The Average Sales Price and the cost-to-produce of the latest iPhones is at heart of the newest debate.



But first let's take a step back at look at why Wall Street is leading this debate...

Wall Street likes to compare itself to Bulls and Bears, animals of great stature. The animals represent those who are positive about stock prices (Bull) versus those who are pessimistic (Bears): so it's a zoological metaphor for positive and negative.

To outsiders those Wall Street mammals sure sound more like squirrels and skunks. While that may sound harsh, the animals may forgive us.

Squirrels are gregarious, the noisy cheer-leaders of nature. Busy up and down the tree all day, chattering away, gathering acorns for rainy days. They tend to leaps of faith while they make dramatic jumps from tree to tree. You can see them sometimes, fully stretched in a beautiful jump... and then the shock when they hit a slippery tree limb for a change... hanging by their front feet...backwards kicking out on thin air...their dignity momentarily gone... until they pull themselves up on the branch...looking around to make sure no one saw the gaff.

Some of them even think they can fly, but it is really a glide. You can't get more optimistic than a squirrel.

Skunks, on the other hand, are not party animals. Skunks are solitary, nocturnal. They are dormant for about a month during the coldest part of the winter. While some consider skunks as pests, they serve a useful purpose in backyard eating insects and reptiles.

You don't bother a skunk because it raises a stink.

If threatened, skunks will stamp their feet, raise their tails and arch their backs. When you are faced with this situation it is wise to retreat. With their patented white stripe down the black back, if it seems like the skunk’s stripes are pointing right to where their defensive spray comes out, that’s because it is. The skunk's strongest defense comes from its butt.

Now to the point: **the Bulls/squirrels and Bears/skunks on Wall Street fight constantly over whether a stock is going up or down, on the value of holding stock in a particular company.** They do this to drive a stock price up or down, depending upon whether they are a Bull or Bear in their stock holdings. A Bull would usually own stock and if the stock price rises, their portfolio increases in value. A Bear might have "short" the stock (that is, placed a bet on the stock's drop) and that price drop enriches the Bear's wallet.

OK, don't ask me about "puts" and "calls." The important thing to know is that Apple, as the world's most valuable company, is a favorite issue of debate on Wall Street. And because there is money involved, stock analysts often have more resources (including access to top executives) than most journalists.

Here is what Wall Street is now talking about: Apple recently reported profits of $11 billion for the quarter that ended in September 2015 on revenue of $51.5 billion. That's more than the combined profits of Google ($4.7 billion) and Microsoft ($5.8 billion). And the year's biggest profits are yet to come, after the holiday shopping season.

But while the squirrels are flying high, some skunks are giving the "SELL your shares NOW" sign on Apple.

Much of the debate for the future of Apple centers on the iPhone and the rise and fall of its sales margin. At any other company, Apple's other products (9.8 million iPads and 5.7 million Macs) would be considered successful products. But Apple is considered by Wall Street to be a one product company. Its value is driven by the iPhone.

The iPhone earned 62% of all Apple revenue last quarter. Apple sold 48 million iPhones in the quarter generating $32 billion in revenue (up from 39 million iPhones and $24 billion in revenue in the same quarter of 2014).

Apple has managed to raise the average price of the iPhones it sells ($670 asp, up $67 from 2014) because customers are opting for models with bigger screens or more storage space.

Teardowns suggest that the $670 iPhone may cost as little as $236 to make. And Apple says its overall gross margin — how much revenue is left after subtracting manufacturing costs for all Apple products — is 39.9% (compared with 38% a year ago and 37% two years ago).

So what's the debate between Wall Street squirrels and skunks regarding Apple's cost-to-build?

Squirrels are arguing the margins are better because the phones cost Apple less. So Apple's margin guidance for the quarter of 39%-40% is perfectly realistic. They predict sales increases as much as 7% and improving margins. So BUY the stock.

Skunks argue that supply chain details (especially from numbers released by Foxconn about its own business) are a negative indicator. They say with component costs increasing from the prior year model, Apple will face some margin contraction. They also see a sales decrease and a recurring hardware cycle that puts pressure on the soon-to-be Apple 7. So SELL the stock, is their suggestion.

The whole issue rests on the cost-to-produce. Here is the latest attempt to factor in "software" to the "build cost" of an iPhone.

Cost Break Down	Amount	
Net revenue per Apple handset (after deducting 7.5% mark-up)	$	666.01
Handset Manufacturing Cost (iPhone 6S and 6S Plus averaged)	$	219.84
Amortized software development	$	93.59
Warranties & Product returns (defect rate for PCs average to 1:190 probability)	$	3.73
Cost of revenue for iPhone (gross margin 47.62%)	$	348.85

Source: Alex Cho

This is based on a statement on Apple's Form 10-K 2015...

"The Company has identified up to three deliverables regularly included in arrangements involving the sale of these devices. The first deliverable, which represents the substantial portion of the allocated sales price, is the hardware and software essential to the functionality of the hardware device delivered at the time of sale. The second deliverable is the embedded right included with qualifying devices to receive on a when-and-if-available basis, future unspecified software upgrades relating to the product's essential software. The third deliverable is the non-software services to be provided to qualifying devices. The Company allocates revenue between these deliverables using the relative selling price method."

And this particular analyst says, "Apple doesn't recognize its revenue at the retail price point, but rather the wholesale price point. *Digital Trends* estimate this cost to be $68.90, but it's actually a little less than that when based on a percentile basis and handset distribution model from UBS. I figure the wholesale to retail markup averages around 7.51% on a consolidated basis."

Hence, the analyst figures he knows better than Tim Cook the real cost of an iPhone and figures Apple is taking a gross margin of 47.62%

Why would Tim Cook distort the truth? It is known that sometimes some companies prefer not to be seen as rapacious...it puts off the buyers. So Wall Street assumes there is a deliberate distortion.

But anyone working at a large company knows how **cost allocation is a political issue**, how the powers in the company juggle definitions and costs to gerrymander the numbers they want to show.

The squirrels and skunks aren't seeing the forest for the trees: Apple 7 may or may not be such a revolutionary product that Apple fans drop their phones and rush to the stores. But the iPhone user base are generally happy folks and will follow the Apple product line-- until someone else creates a better product, In this case, it will take a paradigm shift to blast Apple out of a Number One spot.

And that Number One spot will insure Apple takes a healthy margin. Neither squirrels nor skunks even mentioned the fact Apple in many cases is taking the distributor and retailer margins as well as the manufacturer margins (as Apple owns its own profitable chain of leading retail stores).

The only reason to sell your Apple stock is if you need to cash out because it will cost you in the long run. If that sounds like a squirrel, so be it.

If you stand around long enough saying that Apple has reached an end to its growth, someday you will probably be right. But not today. Today you are just a skunk.

Go **Analysts Argue Over iPhone Break-down Costs**

Go **How Foxconn Reports Raise Apple Questions**