

AAPL POLISHING

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The shareholders of Apple are faced with a dilemma. On the one hand, Steve Jobs, their CEO, has yet again proven that he is a master of product development and promotion. On the other hand, in some circles he has been considered to be a financial wizard as well. Recent events seem to place the spotlight on the wizardry. Is there more of Jafar than of Merlin in the mix?

As we have all heard, Mr. Jobs has admitted to being aware of improper backdating of Options in his role as CEO of the Company. While he claims not to have directly profited from these backdates (a claim not yet proven), his Board of Directors and other senior managers did profit. It is not unreasonable to infer that, other than being just a "good guy" to his friends and a "bad guy" to his shareholders, Mr. Jobs must surely have had a financial motive for allowing these backdatings to occur.

Let's entertain ourselves with some additional information.

In defense of Mr. Jobs, an internal committee study was initiated by Apple and found him innocent of any violation. Furthermore, the Apple Board (some of whom are beneficiaries of the backdating) was quick to support Mr. Jobs and absolve him of any wrongdoing.

Facts seem to prove otherwise.

Mr. Jobs was granted a substantial number of Options in 2000 and 2001. According to findings, some of these Options were backdated. The number of Options was not insignificant: 17,500,000 in total. Apple was quick to point out that Mr. Jobs cancelled these Options and made no profit. What they failed to tell us was that the Options were so far out of the money that they were valueless at the time of cancellation.

In lieu of his valueless Options, Mr. Jobs received 5,000,000 shares of restricted shares in 2003. The Company repurchased these shares in 2006 for \$296,000,000. It's not hard to imagine why Mr. Jobs proudly displays his \$1-per-year salary in the financial statement. Of course, the \$296,000,000 stock repurchase of Mr. Jobs' shares by the Company is not reported as salary, but is disclosed in a footnote.

Another interesting tidbit is generated by the internal committee's remarks. The committee states that the backdating was "limited, isolated, episodic..." The facts don't seem to support this view. Company analysis determined that the originally assigned grant dates for 6,428 grants on 42 dates are not the proper measurement dates. This is hardly "limited," "isolated," or "episodic." The cost to shareholders: \$105,000,000. In addition to this deliberate and regular backdating, evidence shows that Option grants were also front-run (granted just prior to the release of good Company news). Furthermore, the backdating and front-running correspond to Mr. Jobs' rehiring at Apple, Inc.

The table below, taken from Apple, Inc.'s most recent 10-K filing, illustrates the timing and expense of the backdated grants (dollars in millions):

| <u>Fiscal</u> <u>Year</u> | <u>Pre-tax</u> <u>Expense</u> <u>(Income)</u> | <u>After-tax</u> <u>Expense</u> |
|-------------------------------|---|------------------------------------|
| 1998 | (1) | --- |
| 1999 | 8 | 6 |
| 2000 | 13 | 9 |
| 2001 | 19 | 13 |
| 2002 | 29 | 23 |
| 2003 | <u>16</u> | <u>12</u> |
| Total 1998-2003 impact | 84 | 63 |
| 2004 | 13 | 10 |
| 2005 | 7 | 7 |
| 2006 | <u>1</u> | <u>4</u> |
| Total | 105 | 84 |

It is interesting to note that an internal review focused on the fiscal period 1997 through 2003. Per the Table in the same financial statement it appears that additional backdating occurred up to and through 2006.

The Annual Report (10-K) filed December 29, 2006 states:

The internal review and independent investigation discovered no stock option grants after January, 2003 that required accounting adjustments.

If I read the Table correctly, it appears that backdating occurred not only after Sarbanes-Oxley became regulation, but during a period of time when Mr. Jobs signed a certification that the financial statements were "true and correct." If my interpretation is accurate, Mr. Jobs may have signed the document with knowledge that it was incorrect, as evidenced by the dramatic restatements to the financial statements for the years 2002 through 2005.

Even if we assume there was no wrongdoing, I am puzzled that Mr. Jobs, or his CFO, or KPMG (their auditor, who would have been or should have been aware of Options backdating) did not at a minimum disclose this information to their shareholders. I am forced to arrive at the conclusion that this information was intentionally withheld because if disclosed, it would have raised numerous unpleasant questions. So much for transparency.

The Company states in its 2006 Annual Report that there are "inherent limitations over internal controls:"

The Company's internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. The Company's internal control over financial reporting includes those policies and procedures that:

- o *pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the Company's assets;*

- *provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that the Company's receipts and expenditures are being made only in accordance with authorizations of the Company's management and directors; and*
- *provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the Company's assets that could have a material effect on the financial statements.*

The report goes on to state:

In coming to the conclusion that the Company's disclosure controls and procedures and the Company's internal control over financial reporting were effective as of September 30, 2006, management considered, among other things, the impact of the restatement to the financial statements and the effectiveness of the internal controls in this area as of the fiscal years ended 2006 and 2005. Management has concluded, therefore, that control deficiencies resulting in the restatement of previously issued financial statements did not constitute a material weakness in disclosure controls and procedures, or internal controls and procedures over financial reporting, as of September 30, 2006.

In addition to the significant improvements implemented between 2003 and 2005 discussed above, the Company will adopt other measures identified by the Special Committee and management to enhance the oversight of the stock option granting and administration function and the review and preparation of financial statements, including:

- *The Company will engage experienced General Counsel, increase the resources of the Corporate Legal Department, and review the adequacy of its procedures and practices*
- *The CFO will arrange for senior management to undertake professional training to enhance awareness and understanding of standards and principles for accounting and financial reporting, particularly those relevant to stock options*
- *The Company will review all current policies, practices, and controls related to the granting of stock options and provide education and training to those who implement those policies and processes, as needed*
- *The Company will establish improved procedures for regular communication among the General Counsel, the CFO, and stock administrators to improve monitoring of all company practices with regard to stock option grants, including formal written confirmation that all grant dates correspond precisely with the dates authorized*
- *The Company will also establish improved procedures for the review of the preparation and presentation of financial statements by senior management*

I am confident that Mr. Jobs' defense will rest on at least two issues: (1) "I didn't benefit directly," and (2) "I wasn't aware of the problems associated with backdating." He might prevail, in my view, not because either argument holds water, but rather because overall, Mr. Jobs has done a good job for Apple and its shareholders in spite of his wizardry. If he is found innocent of wrongdoing, one major risk remains: should he be unable to find another "pony," and the stock fall, every shareholder will be looking for justice.

I hope that policy coverage levels of Directors & Officers insurance are deep and broad, not only for Apple, Inc. and its auditor, KPMG, but for all the fiduciaries that hold this stock on behalf of their investor clients with the knowledge that there are some serious management issues. This is one time you will not be able to say, "If only I had known...."

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