

Microsoft's financial reporting strategy essay sample



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1. What are the factors that likely explain the difference between Microsoft's market value of equity and its reported book value of equity? One of the factors that explain the difference between Microsoft's market value of equity and its reported book value of equity is the lack of effectiveness to record certain intangible assets such as stock of knowledge (i. e., human capital) customer loyalty, and brand value. These former intangible assets mentioned, provides a formidable amount of earning growth in the future, which determines the company's market value. We also note that the company's choice of cautious (conventional) accounting policies has the effect of discouraging the company's book value of equity. 2. What effect did Microsoft's software capitalization policy have on its financial statements? Ignore any potential tax effects.

a. Assume that 60% of Microsoft's research and development expenses were incurred after technological feasibility was established, that the average product life was two years, and that the company begins amortizing software costs at the beginning of the following year. Estimate the effect of capitalizing software costs on Microsoft's fiscal 1997, 1998, and 1999 income statements and balance sheets. The decision involving whether R&D related costs should be expensed or capitalized has a major influence on both the Income Statement and the Balance Sheet of Microsoft as it will have a direct impact on the most basic accounting procedures and calculations of Microsoft's value and profitability. As listed on the table below, when Microsoft capitalized less of its R&D the company's Balance Sheet would show less assets, which would decrease the value of Microsoft. At the same

time, when more of the costs would be treated as expenses Microsoft's profits on the Income Statement would be lower.

b. Speculate as to why Microsoft chose to expense all software costs as incurred rather than capitalizing a portion of these costs. Expenses such as research and development can create challenges for proper expense recording, as such expenses are usually unclear as they can extend through multiple financial periods and companies such as Microsoft must look to accounting regulations put forth by the IRS, and FASB which provides explicit guidelines for the treatment of software development costs that required capitalization once technological feasibility was established.

To ensure proper recording and reporting of company's financial transactions, we can assume Microsoft's financial decision makers must have reasoned: Microsoft's financial strategists must have determined the technological feasibility of their products may have been near to the completion of the software development process as to make the amount of software costs eligible for capitalization too small to have material impact on the financial statement. The incurred Software research and development costs did not have long useful life. Microsoft's research and development expenses and did not have any future benefits.

3. What effect did Microsoft's revenue recognition policy have on its financial statements? Ignore any potential tax effects. a. Estimate the amount of revenue that Microsoft would have been reported in each year from 1996 through 1999 if Microsoft had not adopted its new revenue recognition policy in 1996.

b. Why do you think Microsoft decided to defer a portion of its revenues in fiscal 1996?

We think that Microsoft decided to defer a portion of its revenues in fiscal 1996 because that decision came at a time when they had an enormous spurt growth in revenues, which suggested Microsoft's decision to hold back revenues was to a certain extent to "slow down" the company's revenue growth. The decision to hold back revenue had the effect of lowering reported revenue growth in the first quarter of 1996 from 88% to 64%, and increasing revenue growth in the first quarter of 1997 from 4% to 15%. The first quarter of 1997 signified the lowest quarterly revenue growth in the Microsoft's history. While the timing of the company's decision to defer revenues appears particularly opportune, the introduction of Windows 95 to the market provides a legitimate reason for the decision.

What we read in the case, the company expected to integrate its Internet technologies into both Windows 95 and Office 97 "at no additional cost to customers." By doing so, sales of the two products were improved by the implicit promises and a portion of those revenues should be deferred into the future. It seems as if the development costs of providing these enhancements have already been incurred and expensed under the company's current treatment of software development costs, the company's deferral of revenues exaggerates the mismatching of expenses with revenues. If we look at the company's policy on revenue recognition, it's more consistent with accrual accounting than is the Microsoft's policy on software development expenses.

4. What was the overall impact of these two policies on Microsoft's fiscal 1997, 1998, 1999 financial statements?

As far as the software development costs are concerned the company contends that since the technology developed has reached technological feasibility, the software development costs should be expensed. Based on this policy the company expensed the software development cost. During the years 1997, 1998, and 1999, the software development cost expenses was 28%, 29% and 23% of the operating income before R&D expense. The company's revenue recognition policy was explained that unearned revenue was not yet recognized in earnings.

The company explained that a part of Microsoft's revenue was earned ratably over the product life, and in case of subscriptions over the license agreement period. The company stressed that the customers receive a part of the company's products over the specified period. The company gave examples of technical support and browser technology, where the customer would receive a part of the product.

5. In your opinion, did Microsoft provide its analysts' with information that was intentionally overly pessimistic? Are there any benefits to the company to being outwardly pessimistic about its future prospects?

There is a strong feeling that the company was outwardly pessimistic about its present performance. One of the main reasons was that Microsoft had a market share of more than 85% of the operating systems share in the PC market. The company had attracted anti-trust litigation and was arguing

in a federal court that it had no monopoly power. Low profits at this time could swing the argument in favor of Microsoft.

There are several other benefits to Microsoft for being outwardly pessimistic. First, if the company shows moderate earnings and net income performance, it avoids complacency in the organization because of excessive profits, and the competitive spirit of its associates is maintained. The benefit is motivation. Second, Microsoft was able to set industry standards in revenue recognition and expensing of software development costs. Microsoft could maintain its leadership position because these standards would be hard to emulate. Third, Microsoft could show its financial strength by showing that it could take deductions from its earnings and still show good financial performance. Finally, Microsoft receives the benefits of conservatism from its policies.

6. Describe Microsoft's overall financial reporting strategy. Why had the company adopted this strategy and why was the SEC concerned about? Microsoft's financial reporting strategy can be considered as conservative. Microsoft used this strategy to deliberately manipulate and maintain steady flow of profits and revenue growth which had allowed Microsoft to set aside reserve funds in order to meet Wall Street's earnings expectations. Another reason Microsoft used this conservative financial reporting strategy was to protect the company from unexpected changes in its industry. Microsoft's efforts of manipulating earnings caused the SEC to take concern because this strategy was considered as misrepresentation of the company's financial position as it involved the practices of mismatching of expenses and earning

misstatement which can be an indication of hiding the true value of the company.