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Business, Company

Business Analysis Using Financial Statements- Microsoft's Financial Reporting

1. What effect did Microsoft's software capitalization policy have on its financial statements? Ignore any potential tax effects. 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.

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

Hence, if Microsoft had not adopted its new revenue recognition policy, the profit before income tax would have been positively changed as follows:

1996= +$560

1997= +$858

1998= +$1470

1999= +$1351

3. What was the overall impact of these two policies in Microsoft's fiscal 1999 return on equity, return on sales (ROS), and asset turnover?

- Effect under new revenue recognition policy:

As we have noticed that adoption of new revenue recognition policy relating

to expensing of R& D expenses has resulted in lower profits, ignoring the taxation effect, we can infer that with lower profits following will be the effect on the following ratios:

i) ROE: Net Income/ Total Equity

Result: Decreased

ii) ROS: Net Income/ Revenue

Result: Decreased

iii) Asset Turnover: Net Income/ Total Assets

Result: Decreased

- Effect on ratios if new revenue recognition policy is not adopted:

As noted from the above calculations, had the company not adopted the new revenue recognition policy, the profits would have been inflated and would have the following effect on ratios:

i) ROE: Net Income/ Total Equity

Result: Increased

ii) ROS: Net Income/ Revenue

Result: Increased

iii) Asset Turnover: Net Income/ Total Assets

Result: Increased