Sierra-online case essay

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Sierra On-Line Case In 1992, Sierra On-Line was deep into the research and development of a variety of games for the competitive entertainment and educational software business.

With a goal of going to market during the holiday season, they had a development schedule that had ballooned from six months to about a year. Sierra On-Line disclosed these development costs and timelines in their financial statements in a way that increased their revenues significantly year-over-year. In this highly competitive marketplace, this capitalization ' fooled' investors and analysts into thinking that Sierra On-Line was a stronger investment than in actuality and was not completely reflective of the economics of the industry. When developing new products, the software industry has to establish a point where products become technologically feasible for actual production. Once established, they forecast future sales and defer other costs.

This action played a large role in deeming the future success for software companies; this was especially integral to Sierra On-Line because at least 40% of its sales were attributed to new titles. SFAS No. 86 defined the guidelines for establishing this point on a product-by-product basis and describing the cost shifts from a complete expense write-off to a capitalized cost based on the amortization of future revenues. Sierra On-Line used the selection of this point to its advantage in comparison to its competitors and in particular through King Quest VI and The Sierra Network (TSN). According to the Forbes article in the case, software companies capitalized about 20% of its R&D costs, but because of the highly competitive landscape and

changing consumer tastes, most of Sierra's direct competitors only capitalized around 10% of its costs.

Newsworthy events show that TSN development costs had significant impact on the operating costs, and though they were still in the test stage, they had determined some revenue ideas based on early subscription numbers. King Quest VI on the other hand had been delayed a month from its initial September launch date. This shift would have a significant effect on the difference between unrealized and actual revenues because delays around the holiday season were detrimental to marketing efforts and the consumer awareness. In their Annual Report (Exhibit 3), Sierra On-Line also outlines exceptions to their amortization period standard including a lengthening for CD-based products.

This period change effectively decreases the amortized development costs for these types of products, which increases the capitalization and therefore the net revenues. Additionally, Sierra describes how proportionally they have increased the number of titles they try to develop simultaneously to mitigate the evolving market and changing consumer demands. For the business of computer entertainment and educational software to succeed, a company needed a creative, quality product that was quick to market. This meant that development from conception to creation (and feasibility) should be the longer stretch of the development and once an idea was recognized as appropriate, it should be quick to production.

In actuality, by delaying some of its titles, Sierra On-Line was stretching both sides of the development timeline. By applying the accounting methods as

they did, Sierra On-Line disregarded the general economy of the business in favor of creating a more appealing financial picture. This fooled investors and other analysts to a point because of its anticipated subscriptions and backordered future sales.