

# Overview of microsoft financial reporting strategy

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The lack of ability to record certain types of intangible assets like customer loyalty, brand value and human capital is the major and the most obvious grounds for the distinction of the market vs. book value of equity. These assets like human capital, brand value and customer loyalty have the potential to provide huge earnings for the company in the future and thus affect the company's market value. The company's choice of accounting policies also has an effect on the book value.

For example, if the company follows a conservative type of accounting policy, then the book value of equity would be depressed and vice versa. Explicit Guidelines for treating software development costs that require capitalization after the technological feasibility has been established have been provided for by the FASB. The determination by Microsoft that the standards did not 'materially affect the company' may rely on the following 2 reasons.

First, when the company may have diagnosed their product's technological feasibility, it might have been late in the developing process to make the software costs on account of capitalization too small to have any far reaching and material effects on the company's financials.

Second, it is also possible that the company may have discovered that the usefulness of the product might have been too short lived, to make the expense costs incurred equal to capitalization.

Microsoft's decision to defer a portion of its revenues was realized at the time of significant growth in revenues, therefore, indicating that the company's decision was to either partially 'smoothen' or 'dampen' the

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revenue growth. This decision had dual effects. It reduced the reported revenue growth to 64% from 88% in the 1st 3 months of 996 and also increased the reported revenue growth to 15% from 4% in the first three months of the fiscal year 1997 (even when the reported revenue growth in 1997 was the lowest in the company's past history). The company's decision to defer a portion of its revenue appears appropriate because of the introduction of Windows 95 in the market.

As is given in the case, the company had thought to integrate Windows 95 and Office 97 with its Internet Technology at no additional costs to its consumers, thus increasing the sales of its products by these types of promises and therefore, a portion of these revenues need to be deferred in the future. Though, these costs of providing enhancements have been treated as an expense under software development costs, the deferred revenue exaggerates, leading to a mismatch between expenses and revenues.

However, still the policy of revenue recognition of the company with accrual accounting is more compatible than the software development expenses. Microsoft follows two accounting strategies for the conservative method of reporting that it follows:

Recognizing of Revenue – Microsoft follows 80-20 policy for recognizing its revenue. Here, 80% is taken into account at sales while 20%, along the life of the product. This was done because of the integration of internet services with windows and Microsoft office for its consumers at no added costs.

Software expenses – The company converted R&D Expenses directly as expenses. The strategic idea of the company was that R&D expense as asset will not bring about any difference to the financials. This was because the R&D procedures had the capability to reduce capitalized expense to a bare minimum as it was believed that the useful life of product was quite small. The company was following the conservative strategy and therefore for showing reduced profits, this plan was followed.

Microsoft also believed in having adequate cash along with short term investments for safekeeping the unanticipated problems/requirements in future.

SEC was worried of reporting followed by Microsoft as it was very uncommon.

1. Concealing profits — The success of the company might have worried them as the firm had an incentive to not show their success to regulators and competitors up to the full extent. The company has had history with regulatory intervention and thus they might want to reduce their performance. However, an important point of notice is that the firm's software capitalization policy occurred before any of the serious interventions.
2. Market Strength — Microsoft has signaled its strong financial strength even when they follow conservative policies by their huge earning numbers.
3. Competition advantage — Microsoft, being the leader has the potential to influence accounting policies that formulate within the industry.

Even the SOP by the AICPA on Software Recognition of Revenue was a result of Microsoft's Policy Decision. Microsoft also has the ability to increase the difficulty level of other firms to portray its good performance by influencing the industry norms and make policies that reduce the earnings and assets of the firm.

4. Avoiding reliance/settling on existing financial figures — The firm reduces its earnings in pursuit of continuous growth and earnings rather than settling on the earned amounts. The company follows the 'constructive paranoia' philosophy regarding its competitive position and the large cash balance Gates' Policy, both of which are in tune with this argument. Also, this is a better clarification for Microsoft's inclination to reduce the analysts' expectations instead of as a clarification for the conservative policies of accounting. However, the argument holds true for both the situations.