

Analysis of microsoft's accounting policy flashcard



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As the most widely recognized company in the world, Microsoft dominated the home computer operating system market with MS-DOS and Microsoft Windows, a graphical extension for MS-DOS in 1980s. The company was founded by Bill Gates and Paul Allen and went public on March 13th, 1986 with the price of \$25.75 per share. Since going public, the company's performance kept being outstanding. Microsoft not only had a high level growth of revenue and operating income, but also achieved this growth in really short period. The net income of Microsoft always grew more than 15% compared to the same quarter in prior years. Thus, the stock price of the company increased significantly, which was almost 100%, since going public.

SEC's investigation

However, Microsoft Corporation was under investigation by Securities and Exchange Commission (SEC) for financial reporting problems on June 30th, 1999. The company's former head of internal auditing, Charles Pancerzewski, charged that Microsoft manipulated its reserve accounts to smooth its earning regularly. By doing so, the company is able to stash accruals during good times and reach them during bad times. In this way, the company can always meet or exceed analysts' expectations. SEC is the first one to investigate Microsoft's financial reporting practices. However, the company insisted on saying that they didn't engage in any improper reporting to manipulate their earnings. And this investigation didn't affect the company's stock price much. What caught SEC's attention was Microsoft's incredibly stable growth rate of earnings every year and how fast they achieved this growth in such a volatile industry.

Microsoft's accounting strategy

According to Generally Accepted Accounting Principles (GAAP), there are two essential areas for software developers: how to record software development costs and when to recognize revenue. Microsoft was known for choosing conservative methods of financial reporting for both of them.

To record software development costs, Microsoft chose to expense all costs as incurred rather than capitalizing them. The Financial Accounting Standards Board (FASB) issued a statement regarding to how to expense and capitalize these costs, which is Statement of Financial Accounting Standards (SFAS) No. 86. The statement pointed out that costs incurred in creating a software product should be expensed when incurred as research and development until the software is feasible. After that, all software production costs should be capitalized. But Microsoft thinks this statement doesn't affect the company materially because software products are short-life products that expensed costs as incurred is almost the same as the capitalization.

For revenue recognition, Microsoft changed their policy in 1996. Before 1996, the company divided the revenue into three categories: revenues from distributors and resellers, revenues from corporate programs and revenues from original equipment manufacturers (OEM). The first one is recognized when the company shipped the products. The second one is recognized when the users installed the software. And the last one is recognized when OEM shipped the products.

Somehow, with the release of Windows 95, Microsoft integrated its Internet technologies, product enhancements, software upgrades and other supports

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to its existing software without incremental costs to customers. These benefits are subsequent deliverables shipped over the lifetime of the product. So Microsoft started to use an 80/20 revenue recognition policy that means 80% of the revenue is gained when shipped, and 20% is delivered over the remaining lifetime of the products. Therefore, the unearned revenue account's balance increased significantly after using the new recognition policy. Software Development Cost Capitalization Policy

Under the US GAAP accounting rules about software (SFAS 86), two milestones are used to determine the treatment of costs incurred in the development process of software. The first milestone is when the technological feasibility, whether the software can be produced to meet its design specification, is established, and the second milestone is when the software product is available for general release to customers. All developmental costs incurred should be expensed before meeting the first milestone, capitalized between the first milestone and the second, and amortized when second milestone is reached.

Microsoft argues that the time between the two milestones is usually too short for the company to capitalize on any significant amount of costs, therefore Microsoft's policy is to expense all research and development costs as they incur regardless of whether the milestones are reached or not. As a result, Microsoft has relatively consistent annual expenses during its software development process compared to companies that capitalize on costs after technological feasibility is established. After the development process is finished, Microsoft's software will start to generate revenue but

will not appear on the company's balance sheet because no costs were capitalized.

To illustrate the impact of Microsoft's cost capitalization policy, consider a specific software that takes three years to develop, its technological feasibility is established at the end of year two, and the developed software will be on the market for two years. The following tables are created with arbitrary values to compare two cases where different R&D capitalization policies are used.

By simultaneously expensing R&D costs as they are incurred, Microsoft has effectively eliminated future amortization expense and allowed the company to report higher earnings in the future. Some analysts and investors argue that Microsoft's conservative policy violates the matching principle and therefore should be stopped; whereas others consider this policy to be reasonable because it has no effect on the company's reported performance in the long run.

Revenue recognition policy

Starting from fiscal 1996, " Microsoft recognizes approximately 20% of Windows operating systems OEM revenue and approximately 35% of retail versions revenue over the product life cycles [...] estimated at two years", which are classified as unearned revenue (Microsoft Corporation [MSFT], 1998, p. 7 Notes to Financial Statements).

The justification given to the adjustment was that in 1996 the company decided to provide free Internet technologies and technical support to its

customers. Under this strategic decision, the old revenue recognition policy no longer conforms to the revenue recognition principle, which states that revenue should be recognized when earned. Since a significant portion of the revenues generated from sales of Windows-based operating systems is attributed to “ future support commitments, Internet browser updates, and other unspecified enhancements”, the management believes that it should be credited to unearned revenue (Microsoft Corporation [MSFT], 1996, Notes to Financial Statements).

Similarly, from 1997, Office 97 is also included in products subject to the new policy because the suite of software programs' subsequent updates, maintenance, and support constitute a material part of the product.

Microsoft disclosed in its Notes to Financial Statements for fiscal year 1997: “ approximately 20% of Office 97 revenue is recognized ratably over the estimated 18-month product life cycle” (Microsoft Corporation [MSFT], 1997, Notes to Financial Statements).

Unearned revenue has been growing quickly every year since 1996, with a rate disproportional to revenue growth. Consequently, this 80/20 policy directly impacts the company's performance. Since no specific disclosure is given to how and when the unearned revenue will be realized, Microsoft estimates its revenue earned by technical support based on the “ price charged or derived value of the undelivered elements” and recognizes the later using the straight-line method over the product's life cycle (MSFT, 1997, Notes to Financial Statements). Prior to 1999, the life cycle of Windows is estimated to be two years. In 1999, the period is extended to three years.

Because it is a change in estimate, it only affects the fourth quarter of 1999 and forward.

Consequently, the unearned revenue account acts as a safe box detached from the economic reality because whether annual sales is booming or declining, a portion of unearned revenue will always flow into the company's annual revenue. This is particularly beneficial to the company to offset or alleviate poor earnings performance when the market is not favorable.

The 80/20 rule is not only conservative from an accounting point of view, but is also a protective strategy from the management. Note that in 1999, Microsoft reclassified its revenue to include revenue generated from product support, consulting, MSN Internet access, and training and certification of system integrators. Those earnings were previously excluded from the company's revenue. Consequently, earnings from previous years were also reclassified due to this change in accounting policies.

The reclassification should not be confused with the change in estimates for unearned revenue, which occurred in the same year. Indeed, following the release of the Statement of Position SOP 97-2, Software Revenue Recognition by the American Institute of Certified Public Accountants (AICPA), Microsoft only reduced its unearned revenue and increased its revenue for the fourth quarter 1999. Effects of the policy on previous years' earnings cannot be observed explicitly since the change was not applied retrospectively. Details of SOP 97-2 will be discussed in the next section.