Microsoft's Financial Strategy:

1 Difference between Market and Book value of equity

- Falling current ratio (current assets / current liabilities)
- High ROE

From Exhibit 1 (Financial performance since initial public offering) in the article, it can be inferred that Microsoft achieved consistently increasing growth in revenues from $140M to around $20B and net income from $24M to around $8B, from years 1985 to1999. This tremendous growth may be one of the reasons for the difference in market value and book value of its equity.

Secondly, it can be seen from the company's financial statements that the current ratio – window dressing

Thirdly, for the year 1999, the market value of each share was around $85, which grew from around $25 in 1986. But the book value of equity is based on the amount of money raised from issuing stocks over the period from 1986 to 1999. This is a likely cause for the difference between the two equities.

The company's current assets to non-current asset ratio, around 1.2 indicates that a major portion of its assets is liquid. This might also be a reason for investors' valuation of the share at $85 compared to its original value of $25, thus contributing to the difference in equities.

2 Effects of Software Capitalization

By writing down research and development costs as expenses as and when they occur, instead of following SFAS No. 86, Microsoft attempted not to capitalize/convert the expenses incurred after the technological feasibility point.

Effects of this:

- Increase in expenses due to R&D and hence decrease in Net income on their Income statement
- If capitalized, the capitalized amount will be conceived or realized as an asset on Balance sheet. Hence, on Balance sheet, Microsoft's assets were of lower worth.

2.a Effect on financial statements

2.a.1 Income statement

From the revised Income statement worksheets, it can be seen that if 60% of the R&D expenses are capitalized and amortized for next 2 years then the Net income will increase by $1117.8 Million, $1001.7Million and $442 Million in years 1997, 1998 and 1999 respectively.

2.a.2 Balance sheet

From the revised Balance sheet calculations, it can be seen that capitalizing and amortizing the 60% of R&D expenses will be represented as R&D capitalization asset. The accrued value of this asset equals to $1117.8M, $2119Million and $3121Million in years 1997, 1998 and 1999 respectively.

2.b Possible Reasons behind Microsoft's decision

- The revised calculation for Balance sheet and Income statements show that had not Microsoft adopted its new policy the actual revenue and asset values would have been higher.

- Due to its new policy, Microsoft was able to report low revenues in all quarters and hence low net income.
- It can be inferred from Microsoft's Balance sheet that the non-current assets are property and equipment, Equity Investments and other assets, which total to $17 Billion. Out of this amount, $14.4Billion is investment in Equity, which can be taken as liquidity. The rest, $2.5 Billion, is their non-current assets. Therefore, their current to non-current asset ratio is around 14, which is outstanding. If Microsoft capitalizes the R&D expenses after technological feasibility point, then this capitalized amount would be written as an asset. This will increase their asset values. In addition, this asset will be realized/conceived as non-tangible and non-current asset. By doing so will decrease Microsoft's current to non-current asset ratio.
- The analysts future expectations will be based on the generated revenue and net income. Analytics future expectations were cut short by these low revenue and net income and Microsoft was successful consistently in reaching analysts future expectation without any problems.

3 Revenue recognition policy

3.a

By adopting to choose some part (20%) of the revenue generated as unearned revenue, Microsoft was successful to reserve cash for its future expenses. In addition, this unearned revenue can be distributed across next few quarters and hence can help normalize any fluctuations in revenue generation (particularly any future downward slopes). This phenomenon can be seen from the exhibit 6 that their revenue was consistently increasing with each quarter.

Particularly, with the recognition of only 80% at the time of sale, Microsoft was able to manage expectations by lowering Wall Streets projections of earnings, which are usually based on the previous quarter earnings. This allowed Microsoft not only to meet the expectations, but also to surpass them. Microsoft was also able to smooth out its earnings curve by having a small store of earnings that were steadily coming into the company. This helped produce the appearance of a much steadier growth which would lead the investors, especially those trying to avoid or reduce risky investments, into believing that the company was a safe purchase. Total revenues for Microsoft for 1995 through 1999 with the adopted revenue recognition policy totals to about $62 billion. So if revenue is recognized all at the same time, there is an additional $4 billion of revenue Microsoft must account for. This would factor into higher expectations of investors and also force Microsoft to pay taxes on an additional amount of revenue.

Overall, it appears that the motive behind the accounting practice of the company has been perception management – on the investors, analysts and probably its own employees.

4 Overall Impact of the above accounting practices

By deferring the revenue recognition, Microsoft was avoiding the tax payment for that revenue. This amount grew and accumulated to $4.2 Billion. Though the revenue was received and available in the form of cash, Microsoft is deferring the recognition of this revenue and subsequently the payment of taxes on it. Further the company could potentially use this as an investment or financing source and hence can reap the benefits equivalent to having a cash reserve of $4.2B but at no capital/user cost.

In addition, by choosing to write down all R&D costs as expenses, including those incurred after technological feasibility point, Microsoft increased its expenses. Had these expenses been capitalized, they would have been amortized in the following years. This way also the company could have realized the tax benefits – but over the future amortizing periods. Thus by not capitalizing R&D expenses, Microsoft has effectively used all its future benefits in advance.