Journal of Accounting and Finance Research
Vol. 12, No. 1
July 2005
pp. xx-xx.

CRITICAL ACCOUNTING POLICY DISCLOSURES OF SELECTED NASDAQ COMPANIES

JOHN O'SHAUGHNESSY AND JOSEF RASHTY

Abstract: Recent major crises in corporate governance led to the passage of the Sarbanes-Oxley Act in July of 2002. The intent of the Act was to restore the confidence of the investors in the integrity of public reporting. At the same time, increased sophistication of complex business transactions has created demands for additional financial information. U.S. corporations since the enactment of the Sarbanes-Oxley Act have made strides in disclosing reliable and relevant information to the public, and the SEC's accelerated filing requirements will improve the timeliness of such information. There is, however, a lack in the filings of some of the public corporations, and there may be areas that disclosures could be improved such that the investors would have the ability to look at the company from the management vantage point. Even though companies are complying with the statutory requirements, they sometimes fail to disclose the judgment that management has exercised regarding the uncertainties surrounding the business environment. This paper evaluates the recent corporate disclosure policies and regulatory requirements by reviewing the 10-K filings of ten technology NASDAQ companies for their critical accounting policies, segment reporting, risk factors, and liquidity disclosures.

INTRODUCTION

The recent wave of crises in corporate governance has led to the passage of the Sarbanes-Oxley Act in 2002. The intent of the Act was to restore investor confidence in public reporting integrity. This Act, together with the increased complexity of business transactions has created a demand for enhanced corporate reporting. As a result, financial professionals, government and regulatory agencies, as well as the public are all demanding that public companies provide more financial information. Management has responded and over the last few years has provided more financial information. Quarterly and annual SEC filings as well as press and earning releases all contain more financial information. However, this increased quantity of information may not equate to enhanced quality as hoped. As a result the SEC has proposed even more stringent disclosure requirements. (SEC 2002a)

Quality financial disclosure such as those which address the financial statement user needs plays an important role in the financial reporting function of publicly held companies; therefore, disclosures can not merely consist of a perfunctory list of general disclosures. To properly provide informative disclosures the preparer must not only have a good knowledge of accounting promulgations but also a good understanding of interdependence among an enterprise's various business segments. The SEC requires that these informative disclosures be contained in a specific section of the public filings

John O'Shaughnessy, Professor, San Francisco State University, joshaun@sfsu.edu
Josef Rashty, San Francisco State University

called the Management Discussion and Analysis. "Communication between investors and public companies could be improved if management explained in MD&A [Management Discussion and Analysis] the interplay of specific uncertainties with accounting measurements in the financial statements." (SEC 2001)

RESEARCH DESIGN

This paper evaluates how recent enactments of corporate disclosure rules have affected the Management Discussion and Analysis (MD&A) disclosures of ten technology companies. Ten NASDAQ-listed companies were judgmentally-selected and their disclosure policies on their 1999 and 2003 10-K filings reviewed. The companies selected represent different segments of the high technology industry as well as a wide range of gross revenue. Based on that criteria five software, three manufacturing, and two Internet services companies were selected. According to their 2003 SEC filings the gross revenue of these companies, ranged between $45 million and $11,500 million annually. This paper reviews the impact of the recent disclosure requirements on these companies including the Critical Accounting Policies section of the MD&A as well as other disclosures such as segment reporting, risk factors, and liquidity.

MANAGEMENT DISCUSSION AND ANALYSIS

The Management Discussion and Analysis is a disclosure requirement for all publicly-traded companies. First introduced by the SEC in 1968 the MD&A must be presented in the quarterly 10Q and annual 10K SEC filings. The content of the MD&A should contain a narrative discussion of the risks and uncertainties facing a company, including their implications for its future liquidity, capital resources and results of operations. According to Zeff (2004) the requirement of the MD&A in 1968, was to address the "increasingly complex and more susceptible to unpredictable change, both domestically and internationally" aspects of business. The SEC felt that investors needed more than what was contained in the financial statements.
Subsequently the MD&A requirements were further developed. Although even more comprehensive in nature, the SEC intended that the content be kept general. This was in line with "the Commission's view that a flexible approach elicits more meaningful disclosure and avoids boilerplate discussions, which a more specific approach could foster." (Zeff 2004)

This narrative approach has long been recognized by the SEC as one that enhances the quantitative measures appearing in the basic financial statements such as earnings. The "MD&A is intended to give the investor an opportunity to look at the company through the eyes of management by providing both a short and long-term analysis of the business of the company. The Item asks management to discuss the dynamics of the business and to analyze the financials." (SEC 1989) The MD&A appears to serve an important function with respect to financial analysis. There is evidence that the MD&A does provide useful information to financial analysts. According to research conducted by Clarkson et al. (1999), the MD&A was found to be a 'source of new and useful information' which is used for financial analysis.

However there continues a struggle to improve the information emanating from the MD&A. In a study conducted by the SEC the financial disclosures of the 2002 annual reports filed for all of the Fortune 500 companies were reviewed for content. In their review they found "companies simply recited financial statement information without analysis or presented boilerplate analyses that did not provide any insight into the companies' past performance or business prospects as understood by management." In addition the SEC found the topics of liquidity, cash flow and capital resources, which were given insufficient attention. (SEC 2003a) Corporate scandals such as Enron and WorldCom have prompted the SEC to further focus its attention on the MD&A content.

The SEC summarized its reaction to the MD&A disclosures. "Investors have become increasingly concerned about the sufficiency of disclosure regarding liquidity risk, market price risk, and effects of 'off-balance sheet' transaction structures. Also, many readers of financial statements have cited a lack of transparent disclosure about transactions with unconsolidated entities and other parties where that information appeared necessary to understand how significant aspects of the business were concerned." (SEC 2002b)

CRITICAL ACCOUNTING POLICIES

On December 12, 2001, the SEC issued guidance on the need for more robust and transparent discussion in the Management Discussion and Analysis (MD&A). The concept of critical accounting policies was initiated with SEC rule FR-60 (SEC 2001). Management should present a clearer discussion of the effect of management judgment in the preparation of financial statements. A discussion of the management judgments used should create to a "greater investor awareness of the sensitivity of financial statements to the methods, assumptions, and estimates underlying their preparation" as well as the probability that materially different amounts would be reported had different conditions occurred or different assumptions used. Additionally, the need to present the critical accounting policies in 'plain English' was emphasized. (SEC 2001) According to Robert Herdman, Chief Accountant of the SEC (2002) in a speech addressing the Financial Executives Institute, he stated that a "critical accounting policy is one that is both very important to the portrayal of the company's financial condition and results, and requires management's most difficult, subjective or complex judgments."

The sensitivity of those judgments to different circumstances should be disclosed. Herdmann (2002) stated that "As the complexity and subjectivity of judgments increase, the inherent level of precision in the financial statements decreases, which is a fact that investors should be told." The rule was to clarify the intention of the SEC with respect to the MD&A. The MD&A is intended to provide investors with an opportunity to look at the company through the eyes of management by providing discussions of the judgments management has exercised in establishing the Critical Accounting Policies of the company. The rule also specifies that boilerplate disclosures do not address a company's particular circumstance and do not satisfy the requirements of the regulations. Thus, disclosures and discussions that could be transferred in a rote manner from year to year are not acceptable. Additionally the disclosures should relate the accounting estimates that a company made in both the adoption and application of accounting policies. The requirement encourages management to describe their judgments as exercised in the selection and application of accounting policies as well as the probability that materially different results if circumstances change. The discussion of the CAPs in the MD&A should be neither a duplication nor a replacement of the notes to the financial statements. The objective is to complement the notes and provide a new prospective for the investors.

Critical Accounting Policies of the Selected Companies

The companies included in the survey had a separate section in their MD&As describing their Critical Accounting Policies. The number of accounting issues covered in the 10-K CAP disclosure was as follows:

Exhibit I **Type of Critical Accounting Policy (n=10)**	**No. of Times Cited in CAP**
Revenue Recognition	9
Allowance for Doubtful Accounts	8
Goodwill and Intangible Assets	7
Deferred Tax Assets	7
Long-lived Assets	4
Long-term Investments	4
Allowance for Sales Returns	4
Employee Stock-based Compensation	2
Property, Plant and Equipment	1
Inventory Valuation	1
Restructuring	1
Valuation of Financial Instruments	1
Legal Contingencies	1
Accounting Expenses and Accruals	1

The most common Critical Accounting Policies discussed (Exhibit I) was Revenue Recognition followed by Allowance for Doubtful Accounts, Goodwill, Intangible Assets, and Deferred Tax Assets. Only one of the companies in the survey did not include its revenue recognition policy in its CAP, but it provided, however, a comprehensive discussion of its policy in the notes to its financial statements

The CAPs disclosed by these companies are far more robust and comprehensive than was disclosed in the notes to their financial statements, but may not have fully addressed the spirit of the SEC requirements. The discussions in most of the CAPs, are limited to a description of Generally Accepted Accounting Principles (GAAP) and conventional accounting policies in some circumstances, were somewhat superficial. A few of the CAP disclosures began with a regurgitation of the pronouncement itself. Clearly, the expectation is that these companies should have followed these principles in the preparation of their financial statements anyway, and as such, a summary elaboration of these rules and principles does not provide any useful information. Further, in most cases, there was limited qualitative and quantitative analysis in the CAPs section of the MD&As reviewed.

CRITICAL ACCOUNTING POLICY DISCUSSIONS OF REVENUE RECOGNITION

Most of the companies reviewed, discussed some of the elements of the American Institute of Certified Public Accountant's (AICPA) Statement of Position (SOP) 97-2, *Software Revenue Recognition* (AICPA 1998b) and its revision, SOP 98-9 (AICPA 1999), and the Financial Accounting Standards Board's Emerging Issues Task Force (EITF) 00-21, *Accounting for Revenue Arrangements with Multiple Deliverables* (FASB 1999) as well as the basic four criteria of revenue recognition from either Staff Accounting Bulletin (SAB) No. 101 – *Revenue Recognition in Financial Statements* (SEC 1999). These pronouncements contain specific as well as subjective criteria for revenue recognition such as those involving the delivery of multiple products and services. For example it is quite often a matter of judgment whether highly discounted, combined software and maintenance contracts are actually providing an additional element. (AICPA 1998a). The disclosure of the discretionary judgments in the selection and application of accounting policies as well as the probability that materially-different results would occur if circumstances change.

None of the reviewed companies discuss in their CAP, the discretionary judgment that management exercised in revenue recognition. For example, only one of the companies reviewed clearly stated its maintenance pricing policy. The particular company stated that its maintenance is priced as a percentage of license fees. The other companies were silent on this matter. Maintenance pricing could be stated as a percentage of license fee or as part of the overall sales. Both policies are acceptable under GAAP, maintenance as a percentage of license fee generates more maintenance revenue consistently throughout the life of the contract because the maintenance revenue is deferred and amortized over the life of the contract. According to SOP 97-2 if a multiple-element software arrangement includes rights to maintenance fees are allocated among the software elements based upon relative fair value of the elements in the contract. For example - If a software vendor contracts to license software to a customer for a list price of $1,000,000 with maintenance fees priced at 20% of the total price of the software. After the first year, the customer has the right to renew annual maintenance on the software at the same percentage. In the first year, $800,000 should be allocated to the software and recognized upon its delivery while $200,000 per year should be recognized over the period during which the maintenance services are to be performed.

Now consider the same facts with a 10% discount on the contract. There are two methods allowed by GAAP to allocate revenue to the software and maintenance portions:

List Price $1,000,000
Maintenance rate 20%
Discount 10%

Example 2a - The Company gives 10% discount

The Company recognizes maintenance revenue as a percentage of list price.

License fee revenue first year $700,000 ($900,000 - $200,000)
Maintenance revenue first year ratably recognized $200,000 ($1,000,000 X 20%)
Maintenance revenue thereafter ratably recognized $200,000

Example 2b - The Company gives 10% discount (same as 2a)

The Company recognizes revenue as a percentage of discounted price (or sell-through method).

License fee revenue first year $720,000 ($900,000 - $180,000)
Maintenance revenue first year ratably recognized $180,000 ($900,000 X 20%)
Maintenance revenue thereafter ratably recognized $180,000

GAAP permits either method, example 2b versus 2a. The difference is that the Company is able to shift the revenue to the current quarter from the upcoming quarters ($720,000 versus $700,000), but it pays for it by sacrificing the future maintenance revenue ($180,000 versus $200,000).

The revenue recognition authorative literature discusses a manner in which to allocate revenue to multiple products sold. Typically it is based upon relative fair value as established by objective evidence. This is called the Vendor Specific Objective Evidence (VSOE). A few companies have discussed their procedures for the determination of their VSOE in their CAP. The determination of the VSOE greatly impacts the financial position of the companies. In the arrangements that include multiple elements regardless of any separate prices stated within a contract for each element, the total fee is allocated based on the VSOE established at their fair values. The discussion, however, in most cases, is a mere duplication of the accounting pronouncements, and little is disclosed in terms of the judgment exercised by management to establish such a VSOE.

EITF 99-19 *(Reporting Revenue Gross as Principal versus Net as an Agent)* provides guidance as to when revenue should be recognized on a gross or net basis. Applicability of one method versus the other has a great impact on the gross margin of the companies. Implementation and impact of EITF 99-19 should probably be discussed in the Revenue Recognition CAP. This is an important issue for some of the segments in the technology industry. Analysts value some technology companies based upon a multiple of revenue rather than earnings. For example the value of Priceline and eBay is calculated in this way. Revenue for these companies may, in some cases, be based on the full price of the products they sell and sometimes based the commissions that they earn from those sales. (Baker 2001) It was not clear from the CAP discussion in the 10-Ks selected if EITF 99-19 was applicable in each particular case or not.

OTHER CRITICAL ACCOUNTING POLICIES DISCLOSED

The discussions and disclosures in the other CAPs (Exhibit I) may not adequately respond, in some cases, to the SEC guidance as well. While some companies provide good information, others do not. Some companies fail to provide the type of sensitivity analysis recommended by the SEC. An SEC member provided some insight as to what he considered important to disclose in the CAP. Herdmann (2002) expounded upon the accounting disclosures surrounding warranty loss estimates. He describes what should be disclosed in the CAP as follows:

a. Clear descriptions of the products.
b. Nature of the costs in the liability measurement.
c. How the estimates process differs between models and product lines.
d. How the company monitors the liability for adequacy.
e. What types of events lead to the difference in the actual and estimated costs.

With respect to the selected companies in this paper the discussions related to the "Allowance for Bad Debt Accounts" some companies only provide a description of the conventional accounting procedures used for the determination of this allowance. There is little discussion on the type of the discretionary judgment that management has exercised to arrive at such estimates. This seems to run counter to the expectations of the SEC.

Below are three examples of doubtful accounts estimates described by three of the selected companies, Companies I, H, and A. The first company's statement appears in the notes to the financial statements only. No mention of estimates is made in the CAP and what does appear is a 'canned' and general format for all of their estimates.

Company I

Use of Estimate [as contained in the notes to the financial statements only.]

> The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent liabilities at the date of the financial statements and the reported amounts of net revenues and expenses during the reporting period. Such estimates relate to the useful lives of assets, assessment of recoverability of property, plant and equipment, intangible assets and goodwill,

> inventory write-downs, allowances for doubtful accounts, customer returns and pricing adjustments, potential reserves relating to litigation and tax matters as well as other accruals or reserves. Actual results may differ from those estimates and such differences may be material to the financial statements.

The second company, Company H, specifically addresses bad debt reserve estimates in both the CAP and notes to the financial statements. Company H disclosure contains more of the elements suggested by Herdmann.

Company H

Bad Debt Reserves [as shown in CAP]

> At June 30, 2003, our bad debt reserve was approximately $112 million. We evaluate the collectibility of our accounts receivable based on a combination of factors. In cases where we are aware of circumstances that may impair a specific customer's ability to meet its financial obligations to us, we record a specific allowance against amounts due to us, and thereby reduce the net recognized receivable to the amount we reasonably believe will be collected. For all other customers, we recognize allowances for doubtful accounts based on the length of time the receivables are past due, industry and geographic concentrations, the current business environment and our historical experience. If the financial condition of our customers deteriorates or if economic conditions worsen, additional allowances may be required in the future, which could have an adverse impact on our future operating results.

Bad Debt Reserves [as shown in the notes to the financial statements]

> We evaluate the collectibility of our accounts receivable based on a combination of factors. In cases where we are aware of circumstances that may impair a specific customer's ability to meet its financial obligations to us, we record a specific allowance against amounts due to us, and thereby reduce the net recognized receivable to the amount we reasonably believe will be collected. For all other customers, we recognize allowances for doubtful accounts based on the length of time the receivables are past due, industry and geographic concentrations, the current business environment and our historical experience. At June 30, 2003 and 2002, our bad debt reserves were $112 million and $114 million, respectively. We expensed amounts related to doubtful accounts of $37 million,

> $46 million, and $25 million for fiscal 2003, 2002 and 2001, respectively.

The third company, Company A, provides the most information concerning the allowance for bad debts.

Company A

Allowance for Doubtful Accounts [as shown in the CAP]

> The Company distributes its products through third-party resellers and directly to certain education, consumer, and commercial customers. The Company generally does not require collateral from its customers. However, when possible the Company does attempt to limit credit risk on trade receivables with credit insurance for certain customers in Latin America, Europe and Asia and by arranging with third-party financing companies to provide flooring arrangements and other loan and lease programs to the Company's direct customers. These credit-financing arrangements are directly between the third-party financing company and the end customer. As such, the Company does not assume any recourse or credit risk sharing related to any of these arrangements. However, considerable trade receivables that are not covered by collateral, third-party flooring arrangements, or credit insurance are outstanding with the Company's distribution and retail channel partners.
>
> The allowance for doubtful accounts is based on management's assessment of the collectibility of specific customer accounts and includes consideration of the credit worthiness and financial condition of those specific customers. The Company records an allowance to reduce the specific receivables to the amount that is reasonably believed to be collectible. The Company also records an allowance for all other trade receivables based on multiple factors including historical experience with bad debts, the general economic environment, the financial condition of the Company's distribution channels, and the aging of such receivables. If there is a deterioration of a major customer's financial condition, if the Company becomes aware of additional information related to the credit worthiness of a major customer, or if future actual default rates on trade receivables in general differ from those currently anticipated, the Company may have to adjust its allowance for doubtful accounts, which would affect earnings in the period the adjustments are made.

Trade Receivables [as shown in the notes to the financial statements]

The Company distributes its products through third-party resellers and directly to certain education, consumer, and commercial customers. The Company generally does not require collateral from its customers. However, when possible the Company does attempt to limit credit risk on trade receivables with credit insurance for certain customers in Latin America, Europe and Asia and by arranging with third-party financing companies to provide flooring arrangements and other loan and lease programs to the Company's direct customers. These credit financing arrangements are directly between the third-party financing company and the end customer. As such, the Company does not assume any recourse or credit risk sharing related to any of these arrangements. However, considerable trade receivables that are not covered by collateral, third-party flooring arrangements, or credit insurance are outstanding with the Company's distribution and retail channel partners. Trade receivables from a single customer, [ABC], Inc., accounted for approximately 10.3% and 10.8% of net accounts receivable as of September 27, 2003, and September 28, 2002, respectively. The following table summarizes the activity in the allowance for doubtful accounts (in millions):

	2003		2002		2001
Beginning allowance balance	$	51	$	51 $	64
Charged to costs and expenses		4		10	7
Deductions (a)		(6)		(10)	(20)
Ending allowance balance	$	49	$	51 $	51

(a) Represents amounts written off against the allowance, net of recoveries.

Of the three companies, the third company illustrated, Company A, provides the most information as to how estimates were formed, the details of the allowance account, and what the company does when differences occur.

CRITICAL ACCOUNTING POLICY DISCUSSIONS OF RESTRUCTURING

At least one member of the SEC considers the accounting issue of restructuring costs to be a troubled area. According to Robert Bayless, (2000) Chief Accountant, SEC in 2000 while addressing the National Association of Black Accountants stated that, "restructuring charges challenged by the staff [SEC] sometimes turned out to be Trojan Horses filled with undisclosed losses and bungle projects, smuggled past unwary investors under the camouflage of labels like 'unusual' or 'isolated.' Too often these charges were loaded with write-offs made necessary by management's prior under-depreciation of assets, and the accruals for ordinary operating costs." The anecdotal experience of the SEC is supported by some research. Research indicates that restructuring costs were used to smooth income. According to Moehrle (2001) the results of his study indicated that firms used "restructuring accrual reversals to manage earnings."

Accounting for restructuring is an important issue because it does affect the investment market. According to Lopez (1999) "the quality of the restructuring disclosure and/or the motive of management for taking the charge has an effect on the informativeness of the restructuring charge components." Chaney et al. (2003) found "evidence that the disaggregation of restructuring charges is informative to investors, and that the market views asset write-offs differently from severance and other cash outlay charges."

Recent authorative literature supports a change in the accounting for restructuring. The commitment to an exit plan or disposal of long-lived assets no longer result in one-time charges as they once had been. SFAS 146 (*Statement of Financial Accounting Standards No. 146, Accounting for Costs Associated with Exit on Disposal Activities*), requires that expenses related to restructuring initiated after 2002, be apportioned and allocated to future periods.

Regardless of the new allocation requirement, estimating the restructuring costs either under SFAS 146, or its predecessor EITF 94-3 *(Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity -- Including Certain Costs Incurred in a Restructuring*), requires management judgment to determine estimates – a potential for CAP inclusion. As Dyson (2003) states the "fair value of a liability for a cost associated with an exit or disposal activity is generally determined by estimating the future cash flows expected to be used in settling the liability, discounted at a credit-adjusted risk-free interest rate. (FASB acknowledged that, in most cases, quoted market prices, ordinarily the best means of determining fair value, do not exist for this type of liability.)" Additionally management must estimate cash expenditures for termination benefits including contingent and penalty fees for early termination.

Although the accounting for restructuring charges requires significant management judgment, only one company included a discussion of restructuring charges as part of its CAPs. Most of these issues were not discussed in detail in the CAPs section of the companies reviewed. One of the companies, however, disclosed the trend of the *revenue per average employee* information, which reveals the impact of the restructuring, and downsizing on the headcount and cost structure of the company – such analytics are quite relevant and informative to the investors. Even though the SEC does not specifically require them, such key variables enable the investors to look at the business through the eyes of the management.

CRITICAL ACCOUNTING POLICY DISCUSSIONS OF IN-PROCESS RESEARCH AND DEVELOPMENT

Another problem for the SEC is In-Process Research and Development (IPR&D). In a letter from Lynn Turner, Chief Accountant of the SEC, to the AICPA (SEC 1998) Turner specifically mentions the valuation and disclosure problems surrounding IPR&D.

> The SEC staff has noted that unreasonable valuations of IPR&D appear to be caused frequently by management's treatment of attributes of capitalized assets as if they were attributes of IPR&D ... SEC staff reviews of filings have noted a number of other problems involving IPR&D. Problems noted include the definition of fair value, purchase price allocations based on appraisals that use an income approach involving forecasted cash flows between IPR&D and other assets, and valuations that employ a "relief from royalty" approach using average industry royalty rates. (This is a hypothetical rate which may not reflect the full value of ownership of a product and all the related intellectual property rights).

While seven of the selected companies showed In-Process Research and Development (IPR&D) costs in their financial statements, only one of the selected companies included a brief discussion in its Critical Accounting Policies. In a related issue, but important to this topic, SFAS 141 (*Statement of Financial Accounting Standards, Business Combinations and Goodwill.)* describes valuation methodologies and values assigned to both core technology (which is capitalized and amortized) and IPR&D (which is expensed immediately.) The method of purchase cost allocation in business combinations can affect current as well as future operating results. This is an area whereby management exercises its judgment and significantly impacts the financial results of the company. There was, however, little discussion and analysis in the CAPs section of the MD&As reviewed regarding the IPR&D allocation.

Segment reporting is a footnote disclosure to the financial statements and not part of the basic financial statements but is required by generally accepted accounting principles as well as SEC regulations. Segment reporting requires a number of assumptions and estimates, the disclosure of which, is required in some form either in a separate MD&A discussion or possibly in the Critical Accounting Policies.

While research shows the benefits of segment reporting (see Lobo et al.), other studies indicate additional complexity is introduced which can lead to errors such as the research performed by Givoly et al. that indicates "measurement errors in segment information, particularly earnings, are larger than those in the financial information reported by single line-of-business firms." Critics of SFAS 131 point to the potential for abuse due to ambiguities arising from the lack of structure. For instance there is no segment profit definition and the internal cost allocation among segments is subject to considerable discretion. (Berger and Hann 2003) Nonetheless research indicates "that the change in segment reporting requirements under SFAS No. 131 has made a relatively significant impact on the disclosure of segment information." (Herrman and Thomas 2000)

As it was with IPR&D, Turner specifies that there were a number of potential problems found by the SEC in segment reporting as well. He states that "in light of recent financial difficulties in a number of foreign markets, it will be critical that the segment disclosures include the appropriate geographical disclosures." (SEC 1998)

With respect to reporting standards, Regulation S-X §210.9-05(a) requires a separate disclosure concerning foreign activities in which either assets, revenue, income (loss) before income tax expense, or net income (loss) associated with foreign entities exceeds ten percent of the corresponding amount in the financial statements. Further, Regulation S-X §210.9-05(c) (3) defines a "significant geographic area" as one which meets the above ten percent rule.

SFAS 131 (*Statement of Financial Accounting Standards No. 131, Disclosure about Segments of an Enterprise and Related Information*) establishes standards for the manner in which public companies report information about operating segments in their annual and interim financial statements. An operating segment is a component of an enterprise whose operating results are regularly reviewed by the chief operating decision maker (COD) for decision-making purposes. The term "COD" according to the SFAS 131, identifies a function, and not necessarily a manager with that specific title. Moreover, SFAS 131 has a similar quantitative threshold for business segment reporting as does Regulation S-X. Nevertheless, defining segments or "significant geographic areas" remains a management function, which, in turn, triggers the ten percent threshold for segment reporting.

The number of the companies that disclosed segments and "significant geographic areas" information in their 10-Ks was as follows:

Exhibit II
Disclosed Segments and Geographical Areas

Period	**Segment**	**Geographic Areas**
1999	6	7
2003	8	10

Thus, the number of the companies disclosing segment and "significant geographic areas" information in their latest filings has increased (Exhibit II). This is consistent with the findings of Street et al. (2000) which indicated that SFAS No. 131 was effective in increasing the number of LOB [line of business] segments reported by some companies, particularly those that had claimed to operate in one LOB under SFAS No. 14. The specific information disclosed in segments or "significant geographic areas" was as follows:

Exhibit III

Type of Specific Information Disclosed	**Occurrences**
Revenue	10
Expenditures	6
Gross Margin	7
Long-lived Assets	7
EBITDA (6)	1
Depreciation and Amortization	1

Thus, all the companies selected disclosed their revenue by segment or "significant geographic area" or both in their latest 2003 filings (Exhibit III). One of the companies reviewed, however, provided additional information comparing the percentage of changes in the results from one period to another in its 10-K using "constant currency disclosure". Under such method, other currencies are converted into U.S. dollars at the exchange rate prevailing on the last day of the prior fiscal year, rather than the exchange rates in effect during the current period. This presentation reveals the percentage of changes in each segment of the company independent of any currency rate fluctuations, and allows investors to assess how the underlying business in each segment performed excluding the effect of the currency rate fluctuations. This information pursuant to paragraph 8 of SFAS 131 is quite relevant since it contributes to a better understanding of the business. SFAS 131 does not intend to discourage an enterprise from reporting any additional useful information, and it follows a "management approach" to segment presentation that each segment should be measured on the same basis as reported to the COD of the company.

Despite an increase in disclosure of segment information in recent years, the SEC has not been satisfied with the progress (SEC 2003a) as indicated by its review of the MD&As of the Fortune 500 company 2002 10-Ks. In several instances, segment disclosures did not appear to be consistent with the information disclosed elsewhere in the filings" (SEC 1998) For example, one of the companies disclosed that its operations rely on a specific geographic area, and even specified that it plans to expand this particular segment of business, but did not disclosed any detail segment information. This appears to be inconsistent with SFAS 131. By virtue of the fact that the COD of the company looks at the profitability of the segment prior to making any business decisions, then it seems it is required for the company to disclose its segment information.

The reasons for the reluctance of public companies to disclose segment information may be perceived to be uneconomic or may create a competitive disadvantage. Despite the reluctance of public companies for segment disclosures, the SEC is exercising more pressure to persuade them to improve their disclosure policies in this area.

MD&A DISCUSSIONS OF RISK FACTORS

Closely related to the contents of the Critical Accounting Policies of a company are the risk factor requirements in the MD&A. According to Herdmann (2002) it is important in the depiction of the company's financial condition and results to investors "if management explained in MD&A the interplay of specific uncertainties with accounting measurements in the financial statements." For this reason the SEC requires that companies disclose in the MD&A the most substantial risks to their business. It further precludes the companies from making generalized statements and requires them to disclose risks associated to their particular environment (SEC 1997).

The risk factors generally fall into one of the following three categories:

- Industry risks – risks that companies face by virtue of the industry within which they work.
- Company risks – risks that are specifically related to a particular company.
- Investment risks – risks that are specifically tied to the investment that company has made in a particular security.

The number of the risk factors reported in the 10-Ks of the companies selected was as follows:

Exhibit IV **Number of Risk Factors**	**Industry Risks**	**Company Risks**	**Investment Risks**	**Total**
1999	42	127	6	175
2003	61	172	11	244
Percentage Increase	45%	35%	83%	39%

The percentage of the risk factors, disclosed in 2003 filings, increased by a total of 39% compared to their 1999 filings (Exhibit IV). The number of the risk factors disclosed was significantly greater in all three categories. This increase could be attributed to the following factors:

- Additional risks due to implementation of new accounting pronouncements that impact the profitability of the company; e.g., expensing of stock options.

- Additional risks due to the downturn of U.S. economy and stock market that might have an adverse affect on the profitability of the company.
- Additional risks due to the performance and liquidity of the company.

It appears that management is less concerned disclosing additional risk factors in the quarterly and annual filings. Most of the risk factors disclosed, however, were generic risk factors and pertain less to a specific management decision.

MD&A Discussions of Liquidity

Another MD&A requirement that contains many assumptions and uncertainties as well as issues that are related to Critical Accounting Policies is the company liquidity discussion. This section of the MD&A focuses on a discussion for the adequacy of cash in the company to satisfy working capital needs during a short-term period (the next twelve months) and during a long-term period (beyond a year.) The expectation is that management should disclose commitments, events, and contingencies that are reasonably likely to materially impact future cash flows and operating results. A discussion of historical analytics, which impacted the cash position of the company, is beneficial to the investors since they are indicative of the future operating performance of the company.

Regulation S-K §229-303 requires, in particular, a discussion of material events and uncertainties that might impact the cash position of the company in the future. The MD&A of some of the companies reviewed included a discussion in this area; however, the SEC is requiring a more substantive analysis, and encourages registrants to provide forward-looking information on the subject. There were, however, very few forward-looking statements in the filings of the companies reviewed.

The companies reviewed discussed and analyzed different segments of their cash flow statements; i.e., operating, financing, and investing activities. All the companies selected prepared their cash flow statements using "indirect method" *(Paragraph 106 of Statement of Financial Accounting Standards 96, Statement of Cash Flows).* The SEC, however, prefers the "direct method" and strongly recommends using this method to describe changes in cash flows and their underlying drivers. The SEC believes that even though the "indirect method" reports the increases and decreases in different components of working capital, it fails to provide a sufficient basis to analyze the changes (SEC 2003c).

Where applicable, there was also a discussion of any of the following subjects:

- Short and long-term cash investment policies in different securities.
- Merger and acquisition activities that might impact the cash position of the company in the future.
- The availability of any credit facility.
- Any future commitment that might impact company's cash position.

- All companies reviewed discussed their cash requirement within the next twelve months, but some of them did not provide any guidance for their long-term cash requirement.

A few companies provided the following analytics to discuss the trends in their cash flows:

Exhibit V **Analytics Disclosures**	**Occurrences**
Daily Sales Outstanding (DSO)	2
Daily Supply of Inventory (DOS)	1
Days Payable Outstanding (DPO)	1
Cash Conversion Cycle	1
Inventory Turns-Product Only	1
Current Ratio (Balance Sheet)	1

Even though the SEC does not specifically require such analytics in the liquidity section of the 10-K, disclosure of such information is quite useful to the investors since it provides the necessary tools for the investors to look at the company from the management perspective.

CRITICAL ACCOUNTING POLICIES NOT DISCLOSED

Even though the information for the following items was disclosed in some other sections of the 10-Ks, they were notably missing in the CAPs section of the companies reviewed. Any of the following items require significant management judgment and estimates in their applications. All of the selected companies had at least two of the following areas of accounting in the basic financial statements. Some of these areas are considered particular problem areas by SEC officials. According to Gordon (2003) Enron had over 4,000 SPEs. This contributed to Enron's complex disclosures which confounded the market valuation of its financial position.

- Off-balance-sheet arrangements, including SPE information.
- Related party transactions.
- Foreign currency transactions.

It is interesting that none of management's judgments concerning any of the above areas were addressed. Within the last two years the SEC has addressed the above issues in the MD&A in a number of final and proposed rules. Here are four of those SEC rules and proposals:

FR-67 - Disclosure in Management's Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations – January 28, 2003. (SEC 2003b)

FR- 72 - Interpretation: Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations - December 19, 2003. (SEC 2003c)

Proposed Rule – Disclosure in Management's Discussion and Analysis about the Application of Critical Accounting Policies – May 10, 2002. (SEC 2002c)

Proposed Rule – Disclosure in Management's Discussion and Analysis about Off-Balance Sheet Arrangements, Contractual Obligations and Contingent Liabilities and Commitments. November 4, 2002. (SEC 2002d)

Each of these proposals and rules further advance the contents of the Critical Accounting Policies appearing in MD&A.

Summary

U.S. corporations since the enactment of the Sarbanes-Oxley Act have made strides in disclosing reliable and relevant information to the public, and the SEC's accelerated filing requirements will improve the timeliness of such information. There is, however, a potential lack of CAP disclosures with some of the public corporations. More SEC regulations will follow and these may improve disclosures such that the investors will have the ability to look at the company from management's vantage point. Even though companies are complying with the statutory requirements, they sometimes fail to disclose the judgment that management has exercised regarding the uncertainties surrounding the business environment. The SEC and the AICPA have realized that it is extremely important to restore investors' confidence in the integrity of public reporting, and there is an expectation of more stringent public reporting requirements with emphasis on the quality of the information. New SEC guidance, issued in late 2003 emphasizes of the disclosures by providing directions on the specifics of the existing requirements. The capital market will certainly benefit from clearer and more reliable financial statements that could result from such rules.

REFERENCES

American Institute of Certified Public Accountants (AICPA). 1998a. Recognize the Software, Recognize the Pitfalls. *Journal of Accountancy – Online Issues.* May. Available at http://www.aicpa.org/pubs/jofa/may98/busind.htm.

American Institute of Certified Public Accountants (AICPA) 1998b. Statement of Position 97-2 Software revenue recognition. *Journal of Accountancy.* (January): 106-120.

American Institute of Certified Public Accountants (AICPA) 1999. Statement of Position 98-9 Modification of SOP 97-2, Software revenue recognition. *Journal of Accountancy.* (March): 95-100.

Baker, C. Richard. 2001. SEC and EITF initiatives on internet accounting. *CPA Journal.* (July). Available at www.nysscpa.org/cpajournal/2001/0700/features/f072601.htm.

Bayless, Robert A. 2000. How the division of corporation finance influences accounting practices and financial reporting standards. July 19. Available at http://www.sec.gov/news/speech/spch394.htm.

Berger, Philip G., Hann, Rebecca. 2003. The impact of SFAS 131 on information and monitoring. *Journal of Accounting Research.* May: 163-223.

Chaney, Paul K., Hogan, Chris E., Jeter, Debra C. 2000. The information content of restructuring charges: A contextual analysis. (December)

Clarkson, Peter M., Jennifer L. Kao, and Gordon D. Richardson. 1999. Evidence that management discussion and analysis (MD&A) is a part of a firm's overall disclosure package. Contemporary Accounting Reseach 16. 111-134.

Dyson, Robert A. 2003. Costs associated with exit or disposal activities. *CPA Journal.* December. Available at http://www.nysscpa.org/cpajournal/2003/1203/features/f122803.htm.

Financial Accounting Standards Board (FASB). 1999. Reporting Revenue Gross as a Principal versus Net as an Agent, EITF Issue No. 99-19. Norwalk, CT: FASB.

Givoly, Dan. Hayn, Carla. and D'Souza, Julia. 1999. Measurement errors and information content of segment reporting. *Review of Accounting Studies.* Vol. 4. 15-43.

Gordon, J. N. 2003. Governance failures of the Enron board and the new information order of Sarbanes-Oxley. Working paper, Columbia Law School. Available at http://www.SSRN.com

Herdman, Robert K. 2002. Critical accounting and critical disclosures. Speech delivered at the Annual SEC Update for the Financial Executives International — San Diego

Chapter, San Diego, California. January 24. Available at http://www.sec.gov/news/speech/spch537.htm.

Herrmann, Don. Thomas, Wayne B. 2000. An analysis of segment disclosures under SFAS No. 131 and SFAS No. 14. *Accounting Horizons*. September: 287-301.
Lobo, Gerald J. Kwon, Sung S. And Ndubizu, Gordian A. 1998. Segment information on price variability and earnings forecast accuracy. *Journal of Business Finance & Accounting*. Vol. 25 (September/October). 969.

Lopez, Thomas J., "Evidence on the Incremental Information Contained in the Components of Restructuring Charges" Journal of Business Finance and Accounting. (November 1999). Available at http://ssrn.com/abstract=184048.

Moehrle, Stephen R., "Do Firms Use Restructuring Charge Reversals to Meet Earnings Targets?" Accounting Review. (October 2001). http;//ssrn.com/abstract=291492.

Securities and Exchange Commission (SEC). 1989. SEC Interpretation: Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures. Securities Act Release No. 6711, supra n. 1, at 13717. Available at http://www.sec.gov/rules/interp/33-6835.htm.

Securities and Exchange Commission (SEC). 1997. Market Risk Disclosure FAQ. January 28. Available at http://www.sec.gov/divisions/corpfin/guidance/derivfaq.htm.

Securities and Exchange Commission (SEC). 1998. Commission Information: Letter From the Office of the Chief Accountant Regarding 1998-1999 Audit Risk Alerts. November 25. Available at http://www.sec.gov/info/accountants/staffletters/aclr1009.htm.

Securities and Exchange Commission (SEC). 1999. SEC Staff Accounting Bulletin: No. 101 – Revenue Recognition in Financial Statements. December 3. Available at http://www.sec.gov/interps/account/sab101.htm

Securities and Exchange Commission (SEC). 2001. Cautionary Advice Regarding Disclosure About Critical Accounting Policies. December 12. FR-60. Available at http://www.sec.gov/rules/other/33-8040.htm.

Securities and Exchange Commission (SEC). 2002a. Proposed rule: Disclosure in management's discussion and analysis about the application of critical accounting policies. May 10. File no. S7-16-02. Available at http://www.sec.gov/rules/proposed/33-8098.htm.

Securities and Exchange Commission (SEC). 2002b. Final rule: Commission statement about Management's Discussion and Analysis of financial condition and results of operations. January 22. FR-61. Available at http://www.sec.gov/rules/other/33-8056.htm.

Securities and Exchange Commission (SEC). 2002c. Disclosure in Management's Discussion and Analysis about the Application of Critical Accounting Policies – May 10. Available at http://www.sec.gov/rules/proposed/33-8098.htm.

Securities and Exchange Commission (SEC). 2002d. Disclosure in Management's Discussion and Analysis about Off-Balance Sheet Arrangements, Contractual Obligations and Contingent Liabilities and Commitments – November 4. Available at http://www.sec.gov/rules/proposed/33-8144.htm.

Securities and Exchange Commission (SEC). 2003a. Summary by the Division of Corporation Finance of Significant Issues Addressed in the review of Periodic Reports of Fortune 500 Companies. February 27. Available at http://www.sec.gov/divisions/corpfin/fortune500rep.htm.

Securities and Exchange Commission (SEC). 2003b. Disclosure in Management's Discussion and Analysis about Off-Balance Sheet Arrangements and Aggregate Contractual Obligations. January 28. FR-67. Available at http://www.sec.gov/rules/interp/33-8350.htm.

Securities and Exchange Commission (SEC). 2003c. Interpretation: Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations. December 19. FR-72. Available at http://www.sec.gov/rules/interp/33-8350.htm.

Street, Donna L. Nichols, Nancy B. Gray, Sidney J. 2000. Segment disclosures under SFAS No. 131: Has business segment reporting improved? *Accounting Horizons*. September: 259-286.

Zeff, Stephen A. 2004. Evolution of US Generally Accepted Accounting Principles (GAAP). Speech delivered at the at an International Symposium on Accounting Standards sponsored by the Ministry of Finance of the People's Republic of China, Beijing, July 12. Available at http://www.iasplus.com/resource/0407zeffusgaap.pdf

List of the Companies

Company A – Apple Computers
Company B – Ask Jeeves
Company C – Macromedia
Company D – Novell
Company E – Oracle
Company F – Saba
Company G – Serena Software
Company H – Sun Microsystems
Company I – Xilinx
Company J – Yahoo