

Critical and significant accounting policies



After Enron's scandal, accounting world underwent dramatic changes. Lots of acts were proposed or released. On May 10, 2002, the Securities and Exchange Commission (which is SEC) proposed a document, that "Disclosure in Management's Discussion and Analysis about the Application of Critical Accounting Policies". One year later, SEC released final rule No. 72, "Interpretation: Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations". First one introduces the framework for critical accounting policies; second one describes how to actually interpret critical accounting policies in the section off Management's Discussion and Analysis (MD&A). However, even till now, people are still in confusion of the differences between those accounting policies: critical accounting policies or estimates and significant accounting policies, a way to actually and precisely disclose these two.

In a more efficient way, I will go through the definition of these two accounting policies first. After that, I will introduce the intent of these two, why we use them. The last but not least, I will use a 10-K form from Apple Inc. to make an example, how we present their contents and formats appropriately.

Definitions

In the accounting standard codification, Financial Accounting Standards Board (which is FASB) has a definition to significant accounting policies, which is "Accounting principles and methods are judged by the appropriate circumstances to present fairly financial position, according to GAAP make financial statement." (Codification, 235-10-05-3) This is very general presentation of financial statement.

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While, in contrast to significant accounting policies, the critical accounting policies and estimates are defined by SEC, which is “ Critical accounting built on assumption about uncertain matters, including period and affect Company’s financial condition” (SEC, 2002).

It is very obvious, that just from the definition of latter: the critical accounting policies and estimates describe only uncertainties of future changes that also have material impacts.

The Differences of Disclosure Intent

The information of significant accounting policies is important and essential for entities’ financial statement users. The significant accounting policies and estimates, which is vital part of the entities’ financial statements, disclose fairly financial position, etc. (Codification, 235-10-50-1). Meanwhile, they are a major component of the financial statements as well. They interpret what accounting policies the entity is currently adopting. FASB also states that, “ the significant accounting policies can affect entity’s financial position, and can be used for making economic decisions” (Codification, 235-10-05-4).

Because of Enron scandal, Securities and Exchange Commission intends to give more information of the entity to investors. The quality of corporate disclosures needs to be improved. I believe the intent of critical accounting policies is to disclose the accounting policies needed management judgments and estimations with the uncertainties. The critical accounting policies are the vital components in note of the management’s discussion and analysis. SEC’s FR-60 interpreted as followed:

Financial position may imply precisions, continuities and certainties that can be rapid changed in the financial status and operating environment. Thus, even general accepted accounting principles (“ GAAP”) maybe more or less fail to present important information if it is not appropriate accompanied or clear analytic disclosed to facilitate an investor’s understanding of the company’s financial condition, and the possible changes in the operating condition (SEC, 2001).

According to above information, we should be aware of that, not only the definitions are different, but also the intents of using these two accounting policies are substantially distinct from each other. FASB’s purpose of significant accounting policies cannot be served for SEC’s critical accounting policies and vice versa.

Contents Presentation

The significant accounting policies defined by FASB for the applications of accounting principles and methods have a wide range of general description. In contrast of that, critical accounting policies and estimates that proposed by SEC only estimate some of the substantially uncertain and material accounting policies.

FASB specifies the disclosure of significant accounting policies should identify the accounting principles and the methods that will materially affect the financial position, and results in different operations, or cash flow. They include judgments, whether principle appropriate between revenue and asset cost during current or future period (Codification, 235-10-50-3).

In this paper, I used Apple annual report as an example. In the Form 10-K/A of Apple Inc. (filed in Jan 25, 2010) include presentation and preparation, fair value measurements, financial instruments, inventories, property plant and equipment, asset retirement obligations, goodwill, foreign currency translation and remeasurement, revenue recognition, shipping costs, allowance for doubtful account, warranty expense, software development cost, income taxes, stock-based compensation, advertising costs, earnings per common share, comprehensive income, segment information. For example, Apple disclosed inventories item at (LCM) lower the of cost, or market, calculated with FIFO (first-in, first-out) method. In recognition item, the Company recognizes revenue when delivery has occurred or any persuasive evidence of an agreement exists. Moreover, in revenue recognition item, for multiple-element arrangements which may include tangible products that contain software that is essential to the tangible product's functionality and undelivered software elements that relate to the tangible product's essential software, the Company allocates revenue to all deliverables based on their selling prices (Form 10K/A, 2009).

Before application, there are requirements that the critical accounting estimates should meet: at the made time of accounting estimates, the uncertain assumption; another is, any kinds of estimates used during current period and changes made in the estimate should impact the financial condition materially. There three elements that are involved in the accounting estimation: the first is to understand the accounting estimates; the second is to give a clearer comprehending to the financial condition for normal investors; the third is to disclose management discussed

development (SEC, 2002). Furthermore, the critical accounting policies and estimates should be as the supplements of notes of financial statements, but not duplicate any related information that already presented. The critical accounting polices disclosure should provide relevance information deeply (SEC, 2003).

From the sec's intention, accountants should take strongly responsibility for the risk of estimates and changes. Moreover, accountants should be able to explain how they came out with the results and estimates. If last year a bank made a lot of relative new loans, so the report would look good. But if many of those borrowers later failed to pay, then this year's report would look very bad. So for the next year, the bank management will be required to estimate how many borrowers would fail to pay, maybe a percentage, and put it in the notes of MD&A.

In the last year's Form 10-K/A of Apple Inc. the critical accounting policies and estimates are related to inventory valuation and inventory purchase commitments, revenue recognition, income taxes, valuation of marketable securities, warranty costs, allowance for doubtful accounts along with the legal and other contingencies. In the section of inventory valuation, Apple Inc. emphasize the critical accounting estimate as followi¹/₄š

The Company must order components for its products and build inventory in advance of product shipments. The Company records a write-down for inventories of components and products, including third-party products held for resale, which have become obsolete or are in excess of anticipated demand or net realizable value.

The Company records accruals for estimated cancellation fees related to component orders that have been cancelled or are expected to be cancelled. Consistent with industry practice, the Company acquires components through a combination of purchase orders, supplier contracts, and open orders based on projected demand information. These commitments typically cover the Company's requirements for periods ranging from 30 to 150 days. (Form 10K/A, 2009)

The inventory item that disclosed in the significant accounting policies is very straightforward and simple, like lower cost or market cost. However, here the company estimates the future inventory by forecasting, and later, if the consumers' or markets' demand changed, which is unpredicted, the company would write-down the records, when it needed.

Also, in revenue recognition section analyzes the possible reductions to revenue

Management was making estimates based on historical experience. If a greater proportion of customers redeem the incentives other than estimated, the Company would record credits to revenue, which would have a decrease on revenue. (Form 10K/A, 2009)

Although, the revenue reduction is estimated by historical records, the future market condition may change, for example, the incremental price protection obligations incur. The additional reduction to revenue would be resulted in. Additionally, the company gave an estimation of unspecified software upgrade revenue: if the Company's ESP for the software upgrade rights related to iPhone would have been fluctuated either higher or lower, the

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Company's net sales of year 2009, would have decreased or increased up to \$50 million as compared to that of last year (Form 10K/A, 2009).

Furthermore, compare with just one sentence in significant accounting policies, the allowance for doubtful accounts section in the critical accounting and estimates presents the very detailed information. Besides the historical experience, the company also considers about the future economic environment, the financial condition. If there is a deterioration of financial condition, the company will have to adjust the allowance accounts, which means the adjustments are going to be made.

The formats

The formats of two accounting policies are significant different, because one is by FASB, and another is by SEC.

The significant accounting policies are disclosed in the notes of the financial statement of item 8 in form 10-K. Under FASB codification: the disclosure format of significant accounting policies is “ in a summary of significant accounting policies at the very beginning of the notes of the financial statements” (Codification, 235-10-50-6). Normally, there is a boilerplate of the disclosure for the significant accounting policies.

Compare to the boilerplate formatted significant accounting policies, the critical accounting policies and estimates are normally presented in plain language. The disclosure format should be clear, that the investor could understand easily (SEC, 2002). With a different disclosure place, the critical accounting policies and estimates are only disclosed in MD&A.

Conclusion

After studying both accounting policies, I find out the significant accounting policies and critical accounting policies and estimates are substantially generated by separate individuals with different disclosure purposes.

Furthermore, as the supplementary of significant accounting policies, critical accounting policies and estimates normally describe some needed adjustments, if the future economic environment and customers or market financial conditions change. Post Enron period, SEC's has taken a very clear-cut stand, for fear of more accounting scandals, by providing more contents about how the uncertainties, assumption, approximation and estimation would affect the company's financial statement in critical accounting policies.