

# ACCOUNTING CONCEPT OF ASSET

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## I

In this paper an attempt will be made to inquiry into what may be termed the accounting concept of asset which is considered one of the basic concepts in accounting.

Some people say that all items which are listed on the assets or the debit side of balance sheet are assets. In this opinion, it is not clear that they list an item on the assets side because they regard it as an asset or they regard an item as an asset because it is listed on the assets side. If the latter, it is a matter of grave concern.

For instance, "Kigyo Kaikei Gensoku" (A Tentative Statement of Accounting Principles) published in 1949 by the Business Accounting Standards Council, The Economic Stabilization Board in Japan allows, under a special condition, the listing on the assets side of extraordinary substantial losses.<sup>1</sup> But it is not assets but loss that is listed on the assets side, which may be evident from the term "substantial losses." Dr. Kurosawa, one of the draftsmen of A Tentative Statement of Accounting Principles, said the reason why such a loss is allowed to be listed on the assets side of the balance sheet, as follows: "It is widely accepted that it is better for business accounting to admit to amortize it by assigning to proper periods",<sup>2</sup> than to treat the total amount as a loss of the period when it was incurred. Therefore, in determining the total sum of assets, the amount of the loss should not be added to the amount of other items which are listed on the assets side, such as cash, merchandise, building and so forth, but to be deducted from the amount of stockholders' equity. Such an accounting procedure, which leads to the adding up mixed items, is allowed under the policy of enabling the enterprise to appropriate as much income as could be appropriated without the incurrance of a loss, by permitting the procedure of not charging the total amount of an extraordinary substantial loss incurred to the earned surplus of the period when the loss was incurred. Therefore, it is illogical and irrational to regard all the items which are listed on the assets side as assets.

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<sup>1</sup> Balance Sheet Principles in A Tentative Statement of Accounting Principles provide as to the extraordinary substantial losses as follows:

"1 (D).....extraordinary substantial losses not to be covered with the net profit for the period and/or with the surplus may be listed on the assets side of the Balance Sheet for a time being in order to amortize them spreading over a period of years, provided that such treatment does not impair the financial soundness of a given enterprise."

<sup>2</sup> Kiyoshi Kurosawa, *New Commercial Law and Accounting Principles*, Kunimoto-shobô, in Japanese, 1955, p. 113.

## II

Someone try to define assets from the veiwpoint of their attribution. We can find some typical definitions belonging to this group as follows:

"Assets represent the properties and property rights or claims owned by an enterprise at the balance sheet date."<sup>3</sup>

"*Asset*—Anything that is subject to private ownership. An asset may be property, the right to receive property, the right to use property or right to receive services."<sup>4</sup>

These are rather legal than accounting because according to them assets are only composed of legal properties or rights to property. Such an approach to assets, as is mentioned in IV, is linked closely with the structure of calculation of period income in business accounting. According to these views, deferred charges to revenue which are accepted as assets in accrual accounting are hardly regarded as assets. This is why these views are considered to be out-of-date, faded and contradictory to modern accounting theory.

There is another way of defining assets from the viewpoint of their attribution. The following are the examples:

"The accounting term for property and resources of an economic nature is *assets*."<sup>5</sup>

"In general, then, the assets are all the physical things and rights (including intangibles) owned by the enterprise which have economic signifance or *value* to the enterprise."<sup>6</sup>

These views are quite the same as the above in respect of defining assets from their attribution. However, while the aforesaid views are conspicuously legal, these views pay attention to the economic aspect or usefulness to the enterprise, such as economic nature or significance and value to the enterprise.

According to the 1957 Accounting Principles of the American Accounting Association, "Assets are economic resources devoted to business purposes within a specific accounting entity; they are aggregates of service-potentials available for or beneficial to expected operations." This statement may also be classified among these views. It should be noted that it regards assets not as existing but as functioning, not as static but as dynamic and not as legal but as economic and that they are defined not predicatively but operationally. Nevertheless, the definitons above-mentioned are not always clear. That is to say, what does the term "economic nature or significance" mean? Unless make this clear, we cannot classify economic resources into assets and non-assets. What does "value to the enterprise" mean? And what are "the service-potentials" mentioned by the American Accounting Association? If these are not made clear, we cannot apply the above-mentioned definitions as a test for distinguishing assets from non-assets. Since these are not explained, it may be said that all the above opinions are nothing but abstractive.<sup>7</sup>

<sup>3</sup> Joseph A. Mouriello, *Intermediate Accounting*, New York, 1950, p. 8.

<sup>4</sup> William H. Childs, *Accounting for Management Control*, New York, 1960, p. 4.

<sup>5</sup> C. Aubrey Smith and Jim G. Ashburne, *Financial and Administrative Accounting*, New York, 1955, p. 15.

<sup>6</sup> William A. Paton and Robert L. Dixon, *Essentials of Accounting*, New York, 1958, p. 16.

<sup>7</sup> In Japan, there is a controversy whether or not service-potentials can be included all which are regarded as assets in the modern accrual accounting. As to various problems concerning assets in "Accounting Principles, 1957, AAA" including the above problem, see the following article.

Toshio Iino, "American Accounting Association (AAA), Accounting and Reporting Standards for Corporate Financial Statements, 1957 Revision, 2" *Business Review Vol. 6 No. 2*, in Japanese, p. 93~.

### III

The all the definitions above-mentioned view the assets in the abstract, but the following is noteworthy because of their concreteness, namely, "For accounting purposes, assets include not only rights and value acquired, but also those costs have not been applied to earnings of the past and that are considered to afford in the production of future revenue."<sup>8</sup>

It should be noted that in this case costs available for the acquisition of future revenue are included in assets. By this definition, firstly, the meaning of economic significance and service-potentials etc. which is not clear in the definitions of the second paragraph of II is partly made clear and, secondly, accounting concept of asset is distinguished from the other concepts of asset. It is evident from the fact that some assets are defined here in connection with revenue that such an approach points an arrow towards income determination. It is a characteristic of this approach that the objective of calculation in accounting is expressed, compared with the others given above which do not refer consciously to the objective of calculation in accounting.

It is not too much to say that the approach to assets from the viewpoint of income determination is today almost general and will be able to be widely supported. As a typical example, we can take the theory of Paton=Littleton. They do not define what are assets as other scholars do but explain the classification of assets. According to them, there are two kinds of assets. One is characterized as "revenue charges in suspense" awaiting some future matching with revenue as costs or expenses<sup>9</sup> and "costs" in the sense of technical factors related to the generation of revenue<sup>10</sup> or 'the pool of technical cost factors'.<sup>11</sup> The other is marked as 'the current funds of the enterprise, including recognized revenue elements in process of collection',<sup>12</sup> such as cash, marketable securities and receivables. In other words, they regard both the costs to be matched with future revenue and the funds of the enterprise as assets. The former are usually called non-monetary assets; the latter monetary assets or resources. Now that assets are classified according to whether they turn into expenses in the future or whether they are directly related with income determination, their classification of assets may be said to be intended for income determination based on receipts and disbursements.<sup>13</sup>

Such an approach to assets as that of Paton=Littleton—which is immediately connected with classification of assets, but from which we can inductively derive their concept of assets—aims at income determination. In spite of this characteristic, we can not say it is wholly satisfactory. For, though it aims at income determination, no reference is made to the role which assets should play in the determination of income.

<sup>8</sup> Wilbert E. Karrenbrock and Harrey Simons, *Intermediate Accounting—Comprehensive Volume*, Cincinnati, 1953, pp. 7~8.

<sup>9</sup> W.A. Paton and A.C. Littleton, *An Introduction to Corporate Accounting Standards*, Chicago, 1940, p. 25.

<sup>10</sup> <sup>11</sup> <sup>12</sup> W.A. Paton and A.C. Littleton, *op. cit.*, p. 26.

<sup>13</sup> As to the system of income determination based on receipts and disbursements, see the following paper.

Toshio Iino, "Accounting Classification of Assets", *The Annals of the Hitotsubashi Academy*, Vol. VII No. 2.

It is, of course, in the balance sheet that assets are represented. If assets are to be defined in terms of income determination as they insist, the relation of the balance sheet and the determination of income or the role of the balance sheet in the determination of income ought to be made clear. Without elucidating the structure of determination of periodic income, it may be impossible to explain accounting concept of asset completely. It is true not only of assets but also equities, revenues and expenses as well.

#### IV

The Commercial Law of Japan stipulates for the qualitative limitation and the quantitative measurement of accounting concepts from the standpoint of the determination of profit available for dividends. In the Law, organization expenses (Article 286), the expenses for issuance of new shares (Art. 286-2), the expenses for issuance and discount on bonds (Art. 287) and interests during construction (Art. 291) are explicitly stipulated as items which may be listed on the assets side of the balance sheet, namely, as deferred items. There is a controversy whether those which are allowed to be deferred are restricted to these four or not. Some insist they are only examples, so that under the code it is admitted to defer the items similar to them, but most of them consider the deferrable items to be restricted to those four which are enumerated in the code. The reason is as follows:

(1) "They are not true assets; they are substantially losses."<sup>14</sup>

(2) "It is hardly to be accepted from the standpoint of creditors to list on the assets side those items which are essentially non-assets as deferred assets if no basis is to be found."<sup>15</sup>

Then, what do they regard as assets? As is clear from the fact that someone defines deferred assets as fictitious assets which are unable to be converted into cash,<sup>16</sup> assets in commercial law are a general term for realizable items.

Such a qualitative limitation on the assets has to do with quantitative measurement, i.e. valuation. In commercial law, the valuation of assets, "shall not exceed the price at the date of preparation of the inventory of assets and liabilities", i.e. the market price at the highest (Para. 1 of Art. 34). There are two kinds of market price: the realizable value and the replacement cost. It is not only evident from the precedents but also unobjectionable from the construction of the law that, of these two, the realizable value is adopted in commercial law. For, where assets are essentially restricted to realizable items, in other words, to those items which have the debt-paying power, the issue in valuation is not the acquisition cost, or the replacement cost, but the adequacy of property or rights to cover debts, i.e. the monetary amount to be obtained through their disposition.

The reason that commercial law takes such a peculiar stand on the nature and extent of assets is that in commercial law all the provisions on accounting, including those on assets, aim, first of all, at the determination of profit available for dividends. That is to say, the sum available for dividends is limited to the amount of assets which would remain after paying

<sup>14</sup> Teruhisa Ishii, *The Commercial Law I*, Keiso-shobô, in Japanese, 1956, p. 404.

<sup>15</sup> Teruhisa Ishii, *op. cit.*, p. 405.

<sup>16</sup> Makoto Yazawa, "Valuation of Assets and Deferred Assets," *Studies in Corporation Law*, Vol. 5, Yûhikaku, in Japanese, 1959, p. 1577.

debts to creditors and capital share to shareholders from enterprise assets and retaining in the business the assets equivalent to legal reserve from the standpoint of creditors. In commercial law, not only assets but also debts, capital share and legal reserve are all considered as the factors in the determination of profit available for dividends. This is the accounting logic found in commercial law.

In commercial law, assets are defined positively in connection with special purpose of calculation and the role of assets in the calculation is made clear, and these are the characteristic of the approach to the concept of assets in the law, compared to the approaches mentioned above. Though commercial law defines the concept of asset from the standpoint of the structure of calculation, the question is its purpose of the calculation. As is evident from the fact that first the amount of debts is deducted from the amount of assets in the determination of profit available for dividends, the primary purpose of the system of calculation is the determination of net worth. Moreover, as is clear from the idea of asset valuation at realizable value, such a computation is based on the assumption of winding-up of the enterprise.<sup>17</sup> As will be stated in Section VI, the purpose of modern accounting is by no means the determination of net worth. Thus though the approach to the concept of assets in commercial law is very sensible its qualitative and quantitative limitation of assets, can not be approved from the viewpoint of modern accounting, because its purpose and method of calculation is quite different from those of accounting.

## V

We may able to say that the theory of Schmalenbach attempts to define assets in connection with the structure of calculation in business accounting. As is generally known, he gives the schema of the balance sheet reconstructed from the standpoint of income determination based on receipts and disbursements, which is as follow:<sup>18</sup>

### *Balance Sheet*

1. Means of Payment (Liquide Mittel)	1. Capital (Kapital)
2. Disbursement not yet Expense (Ausgabe noch nicht Aufwand)	2. Expense not yet Disbursement (Aufwand noch nicht Ausgabe)
3. Disbursement not yet Receipt (Ausgabe noch nicht Einnahme)	3. Receipt not yet Disbursement (Einnahme noch nicht Ausgabe)
4. Revenue not yet Expense (Ertrag noch nicht Aufwand)	4. Expense not yet Revenue (Aufwand noch nicht Ertrag)
5. Revenue not yet Receipt (Ertrag noch nicht Einnahme)	5. Receipt not yet Revenue (Einnahme noch nicht Ertrag)

He considers the balance sheet to be the place where means of payment, capital and "items in suspense" (*schwebende Posten*) which result from the time lag between "receipt and revenue" and "disbursement and expense" are represented till they are settled. Therefore, in his balance sheet, not only assets but such balance sheet items as liabilities and capital

<sup>17</sup> As to the accounting logic underlying commercial law in Japan, see the following paper.

Toshio Iino, "The Logic of Accounting and of Commercial Law," *Economic Seminar*, No. 44, in Japanese, p. 50~.

<sup>18</sup> Eugen Schmalenbach, *Dynamische Bilanz*, 12. Auf., Köln und Opladen, 1956, S. 56.

are characterized from the standpoint of income determination based on receipts and disbursements. Moreover, as is evident from his statement that disbursements which do not become expense in a certain period are represented in the balance sheet till it become expense but that once it become expense it will disappear from the balance sheet,<sup>19</sup> future elements are involved here and in that sense it may be said that continuity of an enterprise is assumed. This is why, despite the formal similarity of his approach to the accounting concepts, including assets, with that of commercial law which I mentioned, Schmalenbach came to a different conclusion.

According to him, the balance sheet represents "items in suspense" in the determination of income and since these items in suspense express "active force" (*aktive Kräfte*) and "passive obligation" (*passive Verpflicht*), the balance sheet representing these items expresses the "composition of forces in the business storehouse of forces" (*Zusammensetzung der Kräfte im Kräftespeicher des Betriebs*). He considers these to be the two main features of the balance sheet. He says that the balance sheet is conducive to showing the composition of stored forces in the enterprise, i. e. the financial position.

However where he argues on the nature of balance sheet which aims at the determination of periodic income (*Erfolgsbilanz*), he insists as follows:

It is not the balance sheet or the determination of net worth but the income determination that takes precedence in the business accounting. Income determination must decide the contents of the balance sheet; the balance sheet does not decide the contents of income determination. Thus, the balance sheet is "not the mistress, but the maid-servant of a given accounting period" (*nicht die Herrin, sondern die Dienerin des Abschlusses*).

This is the characteristic of the balance sheet.<sup>20</sup> According to him, the balance sheet which aims at the determination of periodic income, is the tabulation of remaining accounts after transferring to the nominal account such items of the trial balance of balances, after adjustment, as are related to the income determination. If that is the case, the balance sheet is only the tabulation of the balances of accounts carried forward to the following period, which expresses the balancing items that are not represented in the income statement, i.e. the tabulation of cast-off skins, so to speak. Can we learn, as he argues, "the composition of stored forces" or financial position from the cast-off skins? Here, I should think, along with the passive definition concerning assets that assets are cash and active items resulting from the time lag between "receipt and disbursement" and "revenue and expense", we find the fault and limitation of the theory of Schmalenbach.

How can we define assets from the standpoint of the determination of periodic income?

## VI

According to my opinion, business accounting has three functions: (1) the function of controlling both goods and/or services in a goods and/or services flow and money in a monetary flow by recording them individually and quantitatively, (2) the function of measuring

<sup>19</sup> Eugen Schmalenbach, *a.a.O.*, S. 57.

<sup>20</sup> Eugen Schmalenbach, *a.a.O.*, S. 34.

how capital was employed in the enterprise during a given period and how capital is at a given date by expressing uniformly in money prices the goods flow and the monetary flow, (3) the function of reporting the results to the interested parties. (1) is called the function of accountability, (2) the function of measurement and (3) the function of communication or reporting. In the case of the approach from the standpoint of the system of calculation, among them only the function of measurement comes into question. For, from the standpoint of accountability, it is not necessary to establish the accounting concepts and what is reported to the interested parties is the result of accounting measurement.

The subject matter of accounting measurement is related with capital employment; so we may call the accounting measurement the calculation of capital. We can classify it into two groups: (1) income determination concerning the fact how capital was employed and (2) the calculation of capital concerning capital raising and the result of capital employment. Income determination clarifies income available for appropriation. Whether the financial position of the enterprise is good or bad is judged by the ratios concerning the sources of capital raising and the form of capital employment and by the interrelation of the sources of capital raising and the form of capital employment which are clarified by the calculation of capital. And we can judge the business activity by the ratio of income for the period to the total liabilities and net worth. Income and the capital which serve these purposes are calculated respectively in the income statement and in the balance sheet. And it is in the balance sheet, not in the income statement, that assets are represented. Then, how should assets be understood from the viewpoint of the calculation of capital? This is a problem for us to elucidate.

The corporation acquires money by issuing shares, borrowing or other credit transactions. Money thus obtained is applied to the purchase of goods or services. Some of the goods or services purchased are consumed to produce new products; some lose their values without producing any new products. New products thus produced are sold to bring in money; a part of the money is employed for the appropriation of income, another part for the repayment of borrowed money and the rest for reinvestment. The enterprise does these things repeatedly.

Money acquired is the physical form of what is intended to obtain income and to function as capital. Then goods or services are purchased by means of money, that is, money is converted into goods or services. Hence the substance of goods or services is money or transmutation of money, regardless of their phenomenal form. In other words, capital is functioning as goods or services. Therefore, they should be measured by the amount of money paid in acquisition or to be paid in the future, i.e. the amount of capital invested. Accordingly, even if their value becomes much more than the amount of money invested, their valuation should not exceed the amount disbursed to it. Here is one of reasons why assets are evaluated on the original cost basis. But there is the case when all the amount disbursed to goods not always be recovered or the disbursement loses effect because of deterioration, obsolescence, price decline etc. In such a case, the amount which seems to be unable to recover or the amount which has lost the effect of disbursement must be treated as a loss and the corresponding amount must be subtracted from the amount of goods so that the amount of goods may be reduced to the recoverable amount or the amount beneficial to future operations. Therefore, goods are here considered to be the result of capital investment or monetary disbursement and that beneficial to future operations or recoverable in the future.

But it should be noted that the acquisition of goods is not necessarily attended with disbursement. For example, goods are sometimes acquired through donation. However, materials and machines, whether they are acquired through purchase or through donation, equally contribute to the production of new products; commodities are converted into cash through sale. Since goods acquired through donation as well as those acquired through purchase conduce to earning income, both of them should be treated equally. Unless goods through donation are not included in the calculation of capital, the balance does not represent the sources of capital raising and the result of capital employment correctly, and we cannot expect much from the ratio of income to total liabilities and net worth as the data for the judgement of operating results. In the case of gifts, capital raising takes the form of donation and goods can be looked upon as the physical form of employment of that capital. The basis of quantitative measurement is the amount of money which would be disbursed in the case of purchase. In this way, all the goods are useful to the enterprise so long as the amount disbursed to them has a beneficial effect on future operations, so that they are evaluated by the amount disbursed which is expected to be recoverable or beneficial to future operations.

On the other hand, goods are sold and money flows in. Capital is recovered in this way. But this amount is not always larger than that of invested capital measured as recoverable. Sometimes a loss emerges. Moreover, capital is not necessarily recovered in the form of cash. Some goods are sold on credit and some on note. Therefore, in this case as well as in the case of goods, the uncollectable amount should be estimated and deducted as a loss.

The balance sheet tries to determine and represent periodic income which resulted from capital employment on the basis of the balance of capital as well as to represent statically the sources of raising and the result of employment of the capital actually invested, by assembling in a tabulation the amount of capital invested which is beneficial to future operations and which is recoverable the amount of capital recovered (when capital is recovered in the form of non-money, it is the amount of money collectable in the future) and the amount of capital invested, with a clear statement of the form of employment and recovery of capital invested and the sources of capital raising.

According to this method, the construction of income determination by the balance sheet is illustrated on the next page.

Such a system of income determination on the basis of the calculation of capital is not expressed in the account form of balance sheet or in the ordinary report form of balance sheets, where net income for the period is determined and represented without any elucidation of its substance. Thus, from the standpoint of such a calculation of the balance of capital, *assets are the functional forms of capital invested in the enterprise* and are classified into two major groups: recovered items (monetary assets) and, of capital invested, items beneficial to future operations. The latter are divided into two subgroups: items which will be recovered in the form of sale (inventories) and items which become expenses in a form other than sale (prepaid expenses, deferred charges). Now that assets are the functional form of capital invested, non-monetary assets are measured on the basis of the amount disbursed and monetary assets on the basis of the amount of money useful to the enterprise, i.e. the collectable amount. Consequently, it should be noted that the above definition of assets involves not only the qualitative limitation but also the quantitative limitation of assets on the basis of the calculation of capital.



BALANCE SHEET

## The Amount of Capital Recovered:

Cash		¥ 1,000
Notes Receivable		7,000
Accounts Receivable		<u>5,000</u>
		¥ 13,000
of these, Uncollectable Amounts (Allowance for Bad Debts)		<u>500</u>
The Net Estimated Amount of Capital Recovered		¥ 12,500

## The Amount of Capital Invested:

Capital		¥ 10,000
Surplus		3,000
Notes Payable		6,000
Accounts Payable		<u>5,000</u>
		¥ 24,000
of these,		
Amounts Beneficial to Future Operations		
Building	¥ 5,000	
Prepaid Expenses	<u>500</u>	<u>5,500</u>
Recoverable Amounts		¥ 18,500
Commodities (Cost)	¥ 8,500	
Irrecoverable Amounts	<u>500</u>	<u>8,000</u>
of Capital Invested, Beneficial or Recoverable		¥ 10,500
Net Income for the Period		<u>¥ 2,000</u>