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What is an Asset?

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## What is an Asset?

I am pleased to make my second appearance on the program of this annual national conference on current SEC developments.

The year gone by has been one where the staff has concentrated on promoting the Commission's drive for mark-to-market accounting for marketable debt and equity securities. That policy was set out in Congressional testimony in September 1990 by Chairman Breeden and in December 1990 by James Doty, the Commission's former General Counsel.

We have continued to encourage the Financial Accounting Standards Board, and the financial community in general, to embrace the idea of mark-to-market for marketable securities. Contrary to the perception by some, we have not been promoting mark-to-market for other assets, such as plant and equipment, patents and copyrights, or commercial loans held by banks. What the staff has done, however, is to suggest the idea that, when one is looking to identify impairment of the carrying amount of assets such as stocks, bonds, loans, plant, and patents, it is appropriate to look at the fair value of the asset and compare that fair value to the carrying amount of the asset. And then, when one goes to measure impairment, fair value of the asset would be the appropriate attribute to look at in order to obtain the best and most relevant measure of the impairment. This approach is consistent with the Commission's approach to the measurement of foreclosed assets and in-substance foreclosed assets as announced in Financial Reporting Release 28, issued in 1986. In that Release, the Commission said that market value should be used to measure foreclosed assets and in-substance foreclosed assets, even in a situation where those market values come from an auction market where assets are being bought for speculative purposes.

Also, during the past year, the staff has had discussions with numerous registrants, mostly holding companies of financial institutions, regarding their accounting for marketable debt securities. A good number of those registrants have reclassified all or a portion of their bond holdings from the category of so-called "long-term investments" accounted for at amortized cost to a category of "held for sale" or "available for sale" accounted for at the lower of cost or market or, in the case of certain insurance companies, at market. These reclassifications were in acknowledgement by registrants that their own actions indicated that bonds they owned were in fact not being held to maturity or for the long term. Those registrants also revised their stated accounting policies to bring those stated policies into line with the registrants' actual practices of buying and selling bonds, instead of buying and holding bonds to maturity. I want to make

the point here that the staff was enforcing, administratively, the current literature which is based on cost and not market value; the staff was not moving toward mark-to-market accounting by way of the back or side door as has been suggested in some quarters.

You will hear from Jim Leisenring on the FASB's progress on its impairment and marketable securities projects, so I will not devote additional attention to them at this juncture.

What I would like to spend the balance of my remarks on is a more fundamental issue, namely, the definition of an asset.

Last October, after the meeting of the World Congress of Accountants in Washington, DC, the FASB invited standard setters from around the world, and a few other individuals, to meet at the FASB's offices in Norwalk, Connecticut for a day and half to share ideas about standard-setting in various countries and at the "international" level. During that conference, to which I was invited by the FASB, I was taken by the lack of agreement on basic concepts about financial accounting and reporting. One of those conceptual issues is the definition of an asset. It is clear that one of the major roadblocks to resolving accounting issues here in the United States is lack of agreement on the definition of an asset. As work on international standards proceeds, that may be a problem as well.

So, today, I wish to offer, for the consideration of standard setters and others who seek to improve the state of financial accounting and reporting, an alternative definition of an asset. I suggest this alternative definition to be provocative and to stimulate thought and discussion. I do not mean to imply that this is a definition that the Commission or its staff is proposing or will incorporate into the Commission's rules and regulations or even impose administratively in the day-to-day administration of the securities laws.

Most articulated definitions of an asset refer to "economic benefit" or "future economic benefit" or "probable future economic benefit." For example, the FASB's definition is "probable future economic benefit." The full definition of assets from the FASB's Concepts Statement 3, which originally was issued in 1980 and which now is included in Concepts Statement 6, is as follows: "Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events." The FASB lists three essential characteristics of an asset, as follows: "(a) it [an asset] embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, (b) a particular entity can obtain the benefit and control others' access to it, and (c) the transaction or other event giving rise to the entity's right to or control of the benefit has already

occurred." The FASB goes on, in the same paragraph of Concepts Statement 6, to say: "Assets commonly have other features that help identify them--for example, assets may be acquired at a cost and they may be tangible, exchangeable, or legally enforceable. However, these features are not essential characteristics of assets. Their absence, by itself, is not sufficient to preclude an item's qualifying as an asset. That is, assets may be acquired without cost, they may be intangible, and although not exchangeable they may be usable by the entity in producing or distributing other goods or services..."

The FASB's definition is so complex, so abstract, so open-ended, so all-inclusive, and so vague that we cannot use it to solve problems. It does not require exchangeability, and therefore it allows all expenditures to be considered for inclusion as assets. The definition does not discriminate and help us to decide whether something or anything is an asset. That definition describes an empty box. A large empty box. A large empty box with sideboards. Almost everything or anything can be fit into it. Some even want to fit losses into the definition. When I said in March of last year, as the SEC Observer at the Emerging Issues Task Force, that losses on "hedging" instruments related to anticipated transactions do not qualify as assets under that definition, a lot of people objected to my conclusion, including some members of the Emerging Issues Task Force. At the Commission, we often see proposals for the recognition as assets of operating losses of retail operations in the start-up mode and operating losses of plants in their shake-down phase. The definition seems large enough to some people to accommodate these losses.

We see situations at the Commission, particularly in enforcement cases, where there are long-winded briefs by registrants, their lawyers, their independent auditors, and their expert witnesses, quoting extensively from the FASB's Concepts Statement 6 to support a debit balance in the balance sheet as a fit and proper asset, fully meeting the FASB's definition of an asset. One sees even longer, long-winded briefs in private, civil litigation. In that litigation, both sides, both the defendant and the plaintiff, and all of their expert witness, are citing the same passages from the FASB's Concepts Statement 6 in support of their positions regarding the worthiness or unworthiness of a debit balance in a balance sheet as an asset. What we have, then, in the lawyers' words, are teams of swearing accountants--one swearing "thus and so" and another swearing "such and that"--and they cannot resolve what should be a simple question: whether something is an asset.

What generally happens in practice under the FASB's definition of an asset, is that assets are not recognized unless the reporting enterprise acquires them by paying cash or agreeing to pay cash in the future, or someone contributes something to the reporting

enterprise in return for an ownership interest in the enterprise. Then an asset is said to have a cost. In fact, we accountants sometimes think of the asset and talk about it in terms of its cost, not in terms of the asset itself or the future benefit that may flow from it. That is, the asset is the cost, or the cost is the asset. For example, if an enterprise discovers something of value, say, oil or gold, we do not recognize it as an asset because the enterprise has no cost. When the FASB proposed several years ago that business enterprises recognize as assets things received from others in a so-called non-reciprocal exchange, for example, land received from a government, some people objected. One of the reasons for the objection was that the enterprise receiving the asset had no cost in the asset. I refer to this phenomenon as the cost-per se-is-the-asset syndrome.

I will cite some examples. The AICPA's Accounting Standards Executive Committee has outstanding an exposure draft of a Statement of Position entitled "Reporting on Advertising Costs" that says so-called direct-response advertising costs may be reported as assets if the advertising activity resulted in probable future economic benefits. Thus, the cost is the asset. In oil and gas accounting, either successful efforts as described by the FASB in FASB Statement 19 or full cost as described by the SEC in Regulation S-X, the asset represented in the balance sheet is the cost of finding the oil and gas reserves, not the reserves themselves. In FASB Statement 60, the cost of acquiring insurance contracts is an asset. In AICPA Statement of Position 90-8, the cost of originating or acquiring initial continuing care retirement community contracts is an asset. In FASB Statement 86, the asset is the cost of the computer software, not the future benefit that will flow from the software. In the AICPA Accounting and Auditing Guide, "Audits of Casinos," preopening costs are assets. In the AICPA Accounting and Audit Guide, "Audits of Airlines," and the related Statement of Position 88-1, costs of training flight crews and maintenance crews, prerevenue flight expenses, insurance, and depreciation expense of new aircraft are assets. In the AICPA Audit and Accounting Guide, "Audits of Government Contractors," learning, start-up, or mobilization costs incurred for anticipated but unidentified contracts are assets. In Accounting Principles Board Opinion 21, costs of raising debt finance are assets. In FASB Statement 80, losses on futures contracts related to anticipated but not firmly committed transactions are assets. And, finally, in APB Opinion 16, the cost that is left over in a business combination after the purchase price is allocated to all other assets and liabilities is an asset; it is called cost of acquisition in excess of net assets acquired, or goodwill. Along this same line, the International Accounting Standards Committee has proposed that development costs, the "D" in "R&D," may be recognized as an asset under certain conditions. In all of these cases, it is the cost itself that is identified as the asset, not a probable future economic benefit. It is this same line of

reasoning, that a cost can be an asset, that leads some people to suggest that the FASB should reconsider FASB Statement 2 and allow for recognition of research and development costs as an asset. Note that in none of the cases is the asset represented on the balance sheet exchangeable.

The cost of many assets does not represent anything close to the "probable future economic benefit" to be derived from the asset. For example, the probable future economic benefit of a successful, direct-response advertising campaign may be many multiples of the cost. The future benefit of a discovery of mineral deposits generally bears no relationship whatsoever to the costs of finding the deposits. The future benefits of successful research and development also bear little or no relationship to the costs incurred. The Concepts Statement 6 definition of an asset and the historical cost model that we know and use today do not mesh.

Defining an asset as a probable future economic benefit is to use a high-order abstraction. Under such an approach, if an enterprise owns a truck, the truck per se is not the asset. The asset is the present value of the cash flows that will come from using the truck to haul lumber, or coal, or bread. Yet, in today's practice, the asset represented on the balance sheet is a truck, and users of the financial statements see it as a truck. The users do not see it as the economic benefit that will come from using the truck to haul lumber. I think most people are more comfortable thinking of the asset as a truck instead of an abstraction, instead of the present value of future cash flows or the economic benefit to be derived from it.

I suggest that we try an alternative definition. A simple one. One that is not a large empty box. One that is not a high-level abstraction. I suggest that we try the following definition: "Cash, contractual claims to cash or services, and things that can be sold separately for cash."

The suggested definition would comprehend only real things, not abstractions. Real things such as trucks can be sold. Real things can be pledged as collateral. Real things can be given to charity. Abstract probable future economic benefits cannot be sold, pledged, or given away. The definition would not accommodate a cost as being an asset. Losses would not fit into that definition. Exchangeability is a critical element in that definition.

Let me list a few of the things this alternative definition would include. Obviously, cash. Obviously, claims to cash such as trade receivables, loans receivable, demand deposits at banks, certificates of deposit, cash surrender value of life insurance policies, bills, notes, and bonds issued by governments,

corporations, partnerships, individuals, and trusts. Cash paid in advance for the future use of land and buildings would be included. That definition would include raw materials, finished goods, common stocks, land, buildings, equipment, mineral deposits, air rights, water rights, landing slots at airports, broadcast rights, patents, and copyrights. Work-in-process inventory and fixed assets in the process of construction also would be included on the theory that they can be sold for cash when completed.

Let me list what would be excluded: any cost as such, such as preopening costs. Proportions of assets that arise in proportional consolidation, such as 33 1/3% of cash or accounts receivable or plant held by a joint venture in which venture the reporting enterprise has a one-third interest would be excluded. (The one-third interest in the joint venture itself would, however, be an asset.) Receivables sold with recourse and thus owned by another enterprise would be excluded. Assets leased by lessees would be excluded for the same reason. So would deferred taxes. Goodwill would be excluded because it cannot be sold apart from the business.

I submit that use of that alternative definition would vastly simplify the practice of accounting. Intuitively, I think it would appeal to investors and other users of financial statements. I note, in that regard, that the Association of Investment Management and Research recently has recommended that the cost of goodwill no longer be recognized as an asset. Intuitively, I think the alternative definition would appeal to ordinary men and women who walk up and down Main Street, USA, and those who walk up and down Main Street in foreign countries. They would understand it. I think that ordinary people who are not accountants think that when they see an asset in a balance sheet that the asset is something real, and that it represents value, that is, if it is not cash or a claim to cash, that it can be sold separately for cash. Accounting should not be done for the benefit of accountants. Accounting should result in financial statements that ordinary people will understand and therefore be able to use to make investment and credit decisions.

Accountants also would understand that alternative definition. They could use it to identify things to be reported as assets on balance sheets. They could use it to identify, through exclusion, things not to be reported as assets on balance sheets. We would dispense with all of the long-winded briefs about the fitness of debit balances as assets and the teams of swearing accountants. Assets would be real things. Exchangeable things. Defining assets as real things also would tend to make balance sheets less prone to challenge and thereby reduce litigation against registrants and auditors. Would tend to make balance sheets rock solid. As this audience knows well, auditing the recoverability of a cost, or the impairment of a cost, is hard enough when the cost is associated

with a real thing, where one can look to the market value of the real thing to test for impairment. Auditing the recoverability or impairment of something that is just a cost, a cost not associated with a real thing, is more than hard.

Another benefit to be gained would be improved comparability in financial accounting and reporting. In practice, many of the costs that may be recognized as assets are not recognized as assets by all enterprises. Some enterprises, motivated by income tax considerations or conservatism, or for other reasons, charge to income such costs when incurred, whereas other enterprises recognize the cost as an asset. Thus, in practice, there is a significant degree of noncomparability in financial accounting and reporting with respect, to such costs or such assets. Where noncomparability is most evident, because of the size of the amounts, is in the accounting for the cost of goodwill. The cost of goodwill must be reported as an asset by enterprises domiciled in the USA and reporting under US generally accepted accounting principles but may be charged to shareholders' equity or "reserves" by enterprises domiciled in other countries and not reporting under US generally accepted accounting principles.

Using that alternative definition of an asset of course would not govern or suggest which attribute of the asset ought to be or could be selected for recognition and measurement and reporting on the face of the balance sheet. The acquisition price, or historical cost, could be used for nonmonetary operating assets. Or historical cost updated for changes in the general price level. Or the current cost of similar productive capacity. Or the present value of future cash flows. Or the estimated selling price of the nonmonetary asset. As to financial instruments such as marketable stocks and bonds, the acquisition price or current market value could be used, and I would, of course, suggest market value. Or one could be eclectic and select from the menu of attributes of assets to be recognized and measured that attribute which is judged to provide the most relevant information possible for decision making by investors and creditors, limited of course by cost-benefit constraints.

The definition of an asset that is in use today is too inclusive, overly complex, and vague. I suggest that standard setters take another look at the definition.

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