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Volume 2 Selected Papers

Objectives of Financial Statements

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**American Institute of
Certified Public Accountants**

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Earning Power and Cash Generating Ability

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The paper entitled "Economic Decision Making and The Role of Accounting Information" includes a discussion of the *cash generating ability* of enterprises. The concept of cash generating ability and its relation to financial statement objectives requires elaboration.

Cash Payments to Creditors and Investors

The relevance of cash generating ability to the objectives of financial statements is derived from the importance of cash payments by enterprises to creditors and investors.

Benefits to Creditors and Investors of Cash Payments by the Enterprise

The primary benefits to creditors and investors of an enterprise consist of (a) future cash payments by the enterprise to them and (b) future cash proceeds from selling enterprise securities to others.

Cash payments from the enterprise to its creditors and investors include interest and principal payments, regular and liquidating dividends, and payments for purchase of securities by the enterprise (purchases of debt securities before the principal is due and purchases of treasury stock). Creditors and investors are interested in three aspects of future cash payments: their prospective amounts, their prospective timing, and the related uncertainty associated with both the amounts and the timing.

Cash proceeds from sales of securities to others depends on the prevailing market prices, which are influenced by (1) anticipated cash payments

¹ The payments may be made voluntarily by the management of the enterprise or forced by legal action, stockholder action, merger, etc.

by the enterprise to security holders, (2) assessments of others' expectations of cash payments, and (3) other indirectly related factors which have an impact on determining cash payments by the enterprise to security holders.

Market prices that are heavily influenced by factors other than expected cash payments by the enterprise to security holders are unstable. Some of the prices may be higher than they would otherwise be if only the amount, timing, and uncertainty of cash payments were considered; some may be lower. Arbitraging investors will drive the prices toward those levels reflecting expected cash payments.² Securities that are underpriced in view of expected cash payments will be bought and securities that are overpriced in view of expected cash payments will be sold.

Future cash payments by the enterprise to creditors and investors provide both direct and indirect benefits to creditors and investors. The receipt of future cash payments is a direct benefit. Expectations about future cash payments influence market prices of securities and thus indirectly affect prospective benefits or proceeds derived from selling securities.

Conditions Required for Cash Payments By the Enterprise

Three conditions are required for an enterprise to pay cash to creditors and investors. (1) Payments must not contravene provisions of laws or contracts. (2) The enterprise must be willing to make the payments. (3) Cash must be available for the payments.

Legal and contractual constraints. Even if cash is available to pay creditors and investors, the payments may not be made because of legal or contractual restrictions. These constraints generally apply to payments to residual equity holders. Information about such legal and contractual constraints on cash payments by enterprises to creditors and investors should be provided.

Propensity to make cash payments. Investors and creditors must form judgments as to whether an enterprise will make cash payments to them provided cash is available and not legally or contractually restricted.

Since legal penalties are an effective spur, most enterprises pay debts when due. Preferred and common stock dividends, however, depend largely on enterprise policies.

² "Most modern stock valuation techniques are based upon the present-value theory, which was first set forth in detail by John B. Williams in his *Theory of Investment Value*. Building on the earlier theoretical foundations found in Marshall, Bohm, Bawerk and Irving Fisher, Williams argued that the present value of a share of stock is equal to the summation of all dividends expected to be received from it, discounted to the present at an appropriate rate of interest. He argued that tangible income to the investor—dividends—is the only appropriate base for consideration in the valuation of stock." See Paul F. Wendt, "Current Growth Stock Valuation Methods," *Financial Analysts Journal*, March-April 1965, p. 91.

Financial statements should present information about the history of payments to creditors and investors. Information about the enterprise's plans for future payments should also be provided when the past history of payments is not indicative of future enterprise policy. Such information will enable creditors and investors to form judgments concerning the propensity of the enterprise to make cash payments.

Deferred payments. Cash that is available for payment to creditors or investors but which for some reason is not paid out may nevertheless be a positive factor in terms of the enterprise's cash generating ability. Such cash will be available for investment and thereby will increase the potential for future cash payments. Thus, the deferral of payments by the enterprise may change an individual's evaluation of the enterprise. The three aspects of cash payments—amount, timing, and uncertainty—are changed by the deferral of payments, and an individual's preferences and assessment of these changed factors will influence his overall assessment.

Availability of cash. Although the amount and timing of cash available for future payments to creditors and investors is not known in advance, financial statements should provide information that helps creditors and investors form judgments concerning future availability of cash for these payments. The future availability of cash depends on present holdings of cash and the ability to generate more cash. Financial statements obviously should report the enterprise's present cash holdings, but how can financial statements report on cash to be generated by an enterprise in the future?

Earning Power

The primary goal of most commercial enterprises from inception to dissolution is to return to owners of the enterprise more cash than they originally contributed. The principal activities of an enterprise over its life cycle involve using cash effectively to generate more cash. Enterprises which are successful at this process are said to possess earning power—the ability to generate earnings or income. Earnings over the life of an enterprise are eventually measured by the cash generated and returned to owners net of the amount they invested. Thus, for an enterprise to have earnings or earning power it must possess cash generating ability. In that sense earning power and cash generating ability are synonymous in the long run. Earning power can be defined as the cash generating ability of an enterprise.

Cash Generating Ability

Providing information concerning the ability of an enterprise to generate cash for payment to creditors and investors is a primary function of financial statements because of the importance of those payments to creditors and investors. Determining the types of information required depends on an understanding of the nature of cash generating ability.

Three features of cash generating ability are as follows: (1) it is a present condition; (2) it is a multifaceted condition; (3) it cannot be measured by describing existing cash flows.

Present Prospects

No one knows the actual amount or timing of cash generation in the future. The cash generating ability of an enterprise involves an evaluation of its present ability to generate cash in the future, not the resulting future cash generation. Cash generating ability is present prospects, not future accomplishments. Cash generating ability changes with future events.

The existence of cash generating ability does not mean that cash will automatically be generated in the future. The existence of cash generating ability means, as the term indicates, that the ability to generate cash in the future is *thought to be present*. Cash will only be generated in the future to the extent that the ability is utilized.

Cash generating ability must be distinguished from both past cash receipts and disbursements and actual future cash receipts and disbursements. The relationship between cash generating ability and cash flows is analogous to the relationship between potential energy and kinetic energy.

Multifaceted Concept

Cash generating ability is a multifaceted concept that is not subject to simple quantification or unique assessment. Individuals with the same information may estimate the cash generating ability of an enterprise differently because (a) they estimate its components differently (for example, people may differ on the cash generating potential of an invention), and (b) even if they estimate the components alike, they may evaluate the components and their relative weights differently, because different people have different preferences as to amount, timing, and uncertainty of prospective cash generation.

Since the cash generating ability of an enterprise comprises a complex of attributes of the enterprise that are evaluated differently by different people, information cannot be provided that presents cash generating ability *per se*. Cash generating ability, rather, provides an objective for the structure of information. Information should be structured and presented to aid users in forming their own judgments about the cash generating ability of an enterprise. Information should also permit users to weight the amount, timing, and related uncertainty aspects of cash generating ability in accordance with their own preferences.

Cash Generating Ability Distinguished From Present Cash Flows

Information about present cash flows is insufficient for evaluating cash generating ability. Cash outflows for a machine or for inventory, for example, may increase cash generating ability because the cash generation attributable

to or expected from the machine or inventory is larger than the outflow necessary to acquire the asset. Similarly, present cash inflows such as from a loan or a sale of equipment under a distress condition may in fact indicate a decrease in cash generating ability.

Information Useful for Assessing Cash Generating Ability

In developing the objectives of financial statements, information can be separated into two categories: (1) information useful for assessing cash generating ability that should be included in financial statements and (2) information which, although useful for assessing cash generating ability, should be provided by other means. The first category of information is discussed below.

Information about elements of enterprise resources, obligations, and activities (assets, liabilities, owners' equity, net income, revenue, expenses, financing, and other descriptions of operating and investment events) comprises data from which users can estimate and compare cash generating ability. *Particular aspects* of these elements bear on the implementation of a reporting system which assists users.

The cash generating ability of an enterprise is not simply the ability to obtain cash from the resources presently held. Someone who wants to assess cash generating ability must estimate the proximate future net cash receipts as well as future relationships between cash sacrifices (outflows) and cash benefits (inflows). Financial statements should therefore provide information not only about probable future cash benefits from resources held, but also about relationships between cash sacrifices and benefits that have occurred and factors that may cause changes in those relationships in the future.

Information about relationships between sacrifices and benefits can and should take various forms. Income statements, balance sheets, funds statements and forecasts may all present useful information. Neither taken alone presents sufficient information.

Balance sheet: Sacrifice and benefits of resources held. The acquisition of most resources requires a sacrifice by the acquiring enterprise. Resources held, by definition, are expected to provide benefits. One type of relationship between sacrifices and benefits that can be presented in financial statements is the relationship between sacrifices and expected benefits of resources held. For example, the sacrifices involved in acquiring resources held could be presented in one column of a balance sheet, and the expected benefits from those resources could be presented in a parallel column in the balance sheet. This presentation would aid users in predicting cash consequences of existing assets and liabilities.

Such information could also be used to facilitate attempts to extrapolate future relationships between sacrifices and benefits and thus predict cash consequences due to reinvestment.

The spread between sacrifices and benefits can be used to help appraise the uncertainty of expected benefits. For example, a large spread between sacrifices and expected benefits indicating unusually large expected returns may indicate considerable risk.

The helpfulness of information about the relationship between sacrifices and benefits of resources held is not without limits, however. First, the benefits are not known and must be estimated. Second, the relationships between sacrifices and benefits of resources held may not be typical of past relationships; indeed, they may actually represent a one-time phenomenon. Even if the present relationships are typical of the past, the future may be anticipated to vary significantly from the past. Thus, present relationships are not sufficient for estimating probable future relationships between sacrifices and benefits. In other words, balance sheet information is not enough.

Income Statement: Completed relationships between sacrifices and benefits. Information concerning completed relationships between sacrifices and benefits plays a dominant role in the assessment of cash generating ability. The income statement could be designed to present information so that revenues are considered to be past benefits that will require no future sacrifices, and expenses are past sacrifices that will produce no future benefits. Income is therefore the excess of past benefits over past sacrifices for which the relationship between benefits and sacrifices has been completed.

Attributes of the income statement. An income statement reporting completed relationships between sacrifices and benefits describes those events whose impact on the cash generating ability of an enterprise has already occurred. Information about events whose total impact on cash generating ability is not yet determined is reported in the balance sheet.

Income statement information of this nature can only be used inferentially to assess cash generating ability. It presents historical relationships between sacrifices and benefits (between cash outflows and their related cash inflows) that can be used in estimating what such relationships may be in the future. It does not, however, present explicit information about present or contemplated activities and their cash generating impact.

The funds statement, or statement of financial activities. This statement conveys factual information about events which are presumed to have significant cash consequences. However, this statement does not present any interpretation or analysis concerning the cash consequences. The statement informs the user what has occurred, what has been received or paid, but neither indicates the relationship between these events nor the significance of these events in terms of what is to occur. The income statement and balance sheet represent information about events that have occurred; both sources analyze and interpret these events in terms of past and future consequences, whereas the funds statement makes no such analysis or interpretation. This factual statement is clearly useful as background for the

interpretive statements. It is also useful for revealing either continuity or departure from past patterns of operation.

Forecast information. Forecasts inform users about management's expectations, knowledge of which is an integral element for the assessment of cash generating ability. However, forecasts are necessarily based upon expectations and are possibly biased. The user has no assurance concerning the likely success or attainment of these expectations. Forecasts are necessarily subjective, dealing solely with the future; their validation must await the passage of time. As events occur, each of the other financial statements will report information about events which validate or negate the forecasts.

Each of these statements, therefore, provides different information relevant for assessment of cash generating ability. All of these statements seem necessary to the user in his role of assessing cash generating ability. If the user only considers reported income in making his assessments, he is assuming that the trend of past earnings will continue and remain unchanged in the future. If his analysis is limited in this way, the user would be ignoring many factors reported in other statements, such as sacrifice and benefit relationships reported in the balance sheet, factual information concerning the occurrence of events with expected cash consequences found in the funds statement, and forecasts about expected events. Thus, just as the ability to generate cash is dependent on many factors of enterprise activities, so is the assessment of that ability dependent upon many kinds and sources of information. Financial statements cannot provide all of the information needed for this assessment; however, the objective should be to provide the structure for information which helps users to assess enterprise potential from more than one dimension. No single financial statement satisfies this objective.