Conceptual Framework for Financial Reporting

Chapter 1: The Objective of Financial Reporting

INTRODUCTION

OB1. The first chapter of the conceptual framework establishes the objective of general purpose external financial reporting by business entities in the private sector. (Throughout the framework, the term *financial reports* or *financial reporting* refers to *general purpose external financial reports* or *reporting* and the term *entities* [or *entity*] refers to *business entities* [or *entity*] *in the private sector*.) The objective of financial reporting is the foundation of the framework. Other aspects of the framework—qualitative characteristics, elements of financial statements, definition of a reporting entity, recognition and measurement, and presentation and disclosure—flow logically from the objective. Those aspects of the framework help ensure that financial reporting achieves its objective to the maximum extent feasible.

OBJECTIVE OF FINANCIAL REPORTING—PROVIDING INFORMATION USEFUL IN MAKING INVESTMENT AND CREDIT DECISIONS

OB2. **The objective of general purpose external financial reporting is to provide financial information about the reporting entity that is useful to present and potential investors and creditors in making decisions in their capacity as capital providers.**

GENERAL PURPOSE EXTERNAL FINANCIAL REPORTING

OB3. The objective pertains to financial reporting, not just financial statements. The Board's mandate is the establishment of high-quality financial reporting standards. An objective broadly encompassing financial reporting provides a more complete basis and more useful tool for standard-setting.

OB4. The information provided by general purpose external financial reporting is focused on the needs of the full range of capital providers rather than only on the needs of a particular group. Accordingly, financial reports reflect the perspective of the entity rather than the perspective of the entity's owners, a particular group of its owners, or any other group of capital providers. However, adopting the entity perspective as the basic perspective underlying financial reporting does not preclude including in financial reports information that is primarily directed to the needs of an entity's owners or to another group of capital providers. For example, financial reports often include metrics such as earnings per (common) share, which may be of interest to holders and potential purchasers of those shares. That information, however, is in addition to—not a replacement for—information prepared in accordance with the entity perspective.

OB5. The objective of financial reporting stems from the information needs of external capital providers who lack the ability to prescribe all the financial information they need from an entity and therefore must rely, at least partly, on the information provided in financial reports. Managers and the governing board of an entity (referred to herein collectively as management) are also interested in the entity's ability to generate net cash inflows because that is a significant part of management's responsibility and accountability to the entity's owners. However, management is responsible for preparing financial reports; management is not their intended recipient. In addition, management is able to prescribe the form and content of the information it needs in satisfying its responsibility to owners Information needed to satisfy the specialized needs of management (internal users) and other potential users, such as tax authorities or other governmental agencies that are able to prescribe the information they need from an entity is beyond the scope of the framework.

Primary User Group

OB6. In keeping with the entity perspective, financial reporting should provide information about the economic resources of the entity (its assets) and the claims to those resources (its liabilities and equity). Thus, the external users whose needs are paramount are those who have a claim on the entity – equity investors and creditors. Equity investors and creditors have many common information needs.

a. *Equity investors.* Equity investors in an entity are interested in the entity's ability to generate net cash inflows because their decisions relate to the amounts, timing, and uncertainties of those cash flows. To an equity investor, an entity is a source of cash in the form of dividends (or other cash distributions) and increases in the prices of shares or other ownership interests. Equity investors are directly concerned with the ability of the entity to generate net cash inflows and also with how the perception of that ability affects the prices of its equity interests. Equity investors are also interested in how well the directors and management of the entity have discharged their responsibilities to the owners of the entity.

b. *Creditors.* Creditors, including purchasers of traded debt instruments, provide financial capital to an entity by lending cash (or other assets) to it. Like investors, creditors are interested in the amounts, timing, and uncertainty of an entity's future cash flows. To a creditor, an entity is a source of cash in the form of interest, repayments of borrowings, and increases in the prices of debt securities. Creditors may also have the right to influence or approve certain management actions and therefore may also be interested in how well the directors and management of the entity have discharged their responsibilities.

OB7. As used in the framework, the term *investors* refers to equity investors and includes present and potential holders of equity securities, holders of partnership interests, and other owners. The term *creditors* as used in the framework includes present and potential institutional and individual lenders. (Investors and creditors include both those who obtain their interests from the entity and those who obtain their interests from other holders of the entity's equity or debt instruments. In other words, a party may become an entity's investor or creditor either directly or indirectly.) Both investors and creditors generally provide cash to an entity with the expectation of receiving a return **on,** as well as a return **of,** the cash provided; in other words, they expect to receive more cash than they provided.

OB8. Investors and creditors are the most prominent external groups who use the information provided by financial reporting and who generally lack the ability to prescribe the information they need. Investors' and creditors' decisions and their uses of information have been studied and described to a greater extent, and thus are better understood than those of other external groups. Accordingly, financial reporting is primarily directed to the needs of investors and creditors who lack the ability to prescribe the information they need. Information that meets the needs of external investors and creditors is also likely to be useful to others such as suppliers, customers, employees, governments and their agencies, and members of the public. However, financial reporting is not primarily directed to those other groups.

Decision Usefulness

OB9. Present and potential investors and creditors are interested in financial reporting because it provides information useful for making decisions. Accordingly, the primary focus of financial reporting is to provide information useful for making the decisions that investors and creditors make in their capacity as capital providers. The decisions that investors and creditors make include whether and how to allocate their resources to a particular entity (that is, whether and how to provide capital). When making resource allocation decisions, users are interested primarily in the entity's ability to generate net cash inflows. Part of this analysis might include assessing the effectiveness of management in fulfilling its responsibilities to the existing investors and creditors (management's stewardship responsibilities). Once an investor or creditor has invested capital in a particular entity, the investor or creditor may also make decisions relating to protecting or enhancing its holdings, which may involve matters of governance. When making decisions about governance, such as exercising a voting interest in the entity, a user remains interested in assessing the entity's ability to generate net cash inflows, but may place a greater emphasis on an assessment of management's stewardship. While there can be a difference in emphasis, the financial information about an entity that is useful for making resource allocation decisions and decisions related to protecting and enhancing an invested capital is largely the same.

OB10. Other potential users of financial reports (discussed in paragraph OB26) also have either a direct interest or an indirect interest in an entity's ability to generate net cash inflows. For example, although an entity is not a direct source of cash flows to its customers, an entity can continue to provide goods or services to customers only by generating sufficient cash to pay for the resources it uses and to satisfy its other obligations. Thus, information that meets the needs of investors and creditors is also likely to be useful to members of other groups who are interested in an entity's ability to generate net cash inflows. By focusing on the needs of present and potential investors and creditors, the objective of financial reporting by a particular entity also may satisfy many of the needs of other potential users of that entity's reporting.

Limitations and Evolution of General Purpose External Financial Reporting

OB11. Financial reporting by a particular entity is but one source of information needed by present and potential investors and creditors. Those users of financial reports also need to consider pertinent information from other sources, for example, information about general economic conditions or expectations, political events and political climate, or industry outlook. Users of financial reports also need to be aware of the characteristics and limitations of the information in them. To a significant extent, financial reporting information is based on estimates, rather than exact measures, of the financial effects on entities of transactions and other events and circumstances that have already happened or that already exist. The framework establishes the concepts that underlie those estimates and other aspects of financial reports. The concepts are the goal or ideal toward which standard setters and preparers of financial reports should strive. Like most goals, the framework's vision of the ideal financial reporting is unlikely to be achieved in full, at least not in the short term, because of considerations of technical feasibility and cost. In some areas, users of financial reports (and standard setters) may need to continue to accept estimates based more on accounting conventions than on the concepts in the framework. Nevertheless, establishing a goal toward which to strive is essential if financial reporting is to evolve in a common direction that improves the information provided to investors, creditors, and others for use in making decisions.

INFORMATION ABOUT AN ENTITY'S RESOURCES, CLAIMS TO THOSE RESOURCES, AND CHANGES IN RESOURCES AND CLAIMS

OB12. As noted in paragraph OB7, financial reporting should provide information about the economic resources of the entity (its assets) and the claims to those resources (its liabilities and equity). Financial reporting also should provide information about the effects of transactions and other events and circumstances that change an entity's resources and the claims to them. That information is useful to present and potential investors and creditors for assessing an entity's ability to generate net cash inflows and for assessing the effectiveness with which the entity's management has fulfilled its stewardship responsibilities.

Economic Resources and Claims to Them

OB13. Information about an entity's economic resources and the claims to them—its financial position—can provide a user of the entity's financial reports with a good deal of insight into the amounts, timing, and uncertainty of its future cash flows. That information helps investors, creditors, and others to identify the entity's financial strengths and weaknesses and to assess its liquidity and solvency. Moreover, it indicates the cash flow potentials of some economic resources and the cash needed to satisfy most claims of creditors. Some of an entity's economic resources, such as accounts receivable or investments in debt instruments, are direct sources of future cash inflows. In addition, many creditors' claims, such as accounts payable or outstanding debt instruments, are direct causes of future cash outflows. However, many of the cash flows generated by an entity's operations result from combining several of its economic resources to produce, provide and market goods or services. Although those cash flows cannot be identified with individual economic resources (or claims), investors and creditors need to know the nature and quantity of the resources available for use in an entity's operations, which is provided by information about its financial position. That information is also likely to help those who wish to estimate the value of the entity, but financial reports are not designed to show the value of an entity. Estimating the value of an entity would require considering information in addition to that provided in financial reports, for example, general economic conditions in the industry in which the entity operates.

OB14. Information about an entity's financial structure, as reflected in its financial position, helps users to assess its needs for additional borrowing or other financing and how successful it is likely to be in obtaining that financing. It also helps users to predict how future cash flows will be distributed among those with a claim on the entity's economic resources.

Changes in Economic Resources and Claims to Them

OB15. Information about effects of transactions, other events, and circumstances that change an entity's economic resources and the claims to them also helps a user of the entity's financial reports to assess the amounts, timing, and uncertainty of its future cash flows. Such information also helps a user assess the effectiveness with which management of the entity has discharged its duties and responsibilities to the capital providers of the entity. That information includes quantitative measures (and other information) about an entity's financial performance measured by accrual accounting, its cash flows during a period, and changes in economic resources and claims that do not directly affect cash.

Financial Performance Measured by Accrual Accounting

OB16. Accrual accounting attempts to reflect the financial effects of transactions and other events and circumstances that have cash (or other) consequences for an entity's resources and the claims to them in the periods in which they occur or arise. The buying, producing, selling, and other operations of an entity during a period, as well as other events that affect its economic resources and the claims to them, often do not coincide with the cash receipts and payments of the period. The accrual accounting information in financial reports about an entity's resources and claims and changes in resources and claims generally provides a better basis for assessing cash flow prospects than information solely about the entity's current cash receipts and payments. Without accrual accounting, important economic resources and claims to resources would be excluded from financial statements.

OB17. Information about an entity's financial performance during a period measured by changes in its resources and the claims to them, other than claims resulting from transactions with owners as owners, is critical in assessing the entity's ability to generate net cash inflows. That information indicates the extent to which the entity has increased its available economic resources, and thus its capacity for generating net cash inflows, through its operations rather than by obtaining additional financing from investors or creditors. An entity's financial performance provides information about the return it has produced on its economic resources. In the long run, an entity must produce a positive return on its economic resources if it is to generate net cash inflows and thus provide a return to its investors and creditors. The variability of that return is also important, especially in assessing the uncertainty of future cash flows, as is information about the components of that return. Investors and creditors usually find information about an entity's past financial performance helpful in predicting the entity's future returns on its resources, which will be its future financial performance.

Financial Performance Measured by Cash Flows during a Period

OB18. Information about an entity's cash flows during a period is another aspect of its financial performance that helps users to assess the entity's ability to generate future net cash inflows. Information about an entity's cash flows during a period indicates how it obtains and spends cash, including information about its borrowing and repayment of borrowing, its capital transactions, including cash dividends or other distributions to owners, and other factors that may affect the entity's liquidity or solvency. Investors, creditors, and others use information about cash flows to help them understand an entity's business model and operations, evaluate its financing and investing activities, assess its liquidity or solvency, or interpret information provided about financial performance. Cash flow information provides a perspective on the entity's economic activities that is different from the one provided by accrual accounting—a perspective that is largely free from the measurement and related issues inherent in accrual accounting.

Changes in Resources and Claims That Do Not Affect Cash

OB19. Financial reporting should also provide information about changes in an entity's economic resources and claims to them that do not affect cash. Examples include acquiring economic resources in exchange for creditors' claims, settling creditors' claims by transfers of noncash resources, and converting creditors' claims into ownership claims. Investors, creditors, and others need that information to fully understand information about an entity's financial position and financial performance. It also helps users understand the information provided about cash flows during a period.

Management's Explanations

OB20. Financial reporting should include management's explanations and other information needed to enable users to understand the information provided. The usefulness of financial reports to investors, creditors, and others in forming expectations about an entity is enhanced by management's explanations of the information in them. Management knows more about the entity and its affairs than external users do and can often increase the usefulness of financial reports by identifying particular transactions and other events and circumstances that have affected the entity or may affect it in the future and by explaining their financial effects on the entity. In addition, financial reporting often provides information that depends on, or is affected by, management's estimates and judgments. Investors, creditors, and others are aided in evaluating estimates and judgmental information by explanations of underlying assumptions or methods used, including disclosure of significant uncertainties about principal underlying assumptions or estimates.

Financial Reporting Usefulness in Assessing Cash Flow Prospects

OB21. To help achieve its objective, financial reporting should provide information to help present and potential investors and creditors and others to assess the amounts, timing, and uncertainty of the entity's future cash inflows and outflows (the entity's future cash flows). That information is essential in assessing an entity's ability to generate net cash inflows and thus to provide returns to investors and creditors.

OB22. An entity's investors and creditors (both present and potential) are directly interested in the amounts, timing, and uncertainty of their cash flows from dividends, interest, and the sale, redemption, or maturity of securities or loans. However, the prospects for those cash flows depend on the entity's present cash resources and, more importantly, on its ability to generate enough cash to pay its employees and suppliers and satisfy its other operating needs, to meet its obligations when due, to reinvest in operations, and to distribute cash to owners (for example, to pay cash dividends). The judgments of capital market participants about the entity's ability to generate net cash inflows affect the values of debt or equity interests. Therefore, those judgments also may affect cash flows to investors and creditors through sale of their interests.

Financial Reporting Usefulness in Assessing Stewardship

OB23. Management is accountable to owners (equity investors) for the custody and safekeeping of the entity's economic resources, and for their efficient and profitable use. Management is also often accountable to creditors by virtue of contractual arrangements. Management's responsibilities include protecting the entity's economic resources, to the extent possible, from unfavorable economic effects of factors in the economy such as inflation or deflation and technological and social changes. Management is also accountable for ensuring that the entity complies with applicable laws, regulations, and contractual provisions. Management's performance in discharging its responsibilities, often referred to as stewardship responsibilities, is particularly important to existing investors when making decisions about whether to replace or reappoint management, how to compensate management, and how to vote on shareholder proposals about management's policies and other matters. Because management's performance in discharging its stewardship responsibilities usually also affects an entity's ability to generate net cash inflows, management's performance is also of significant interest to potential investors and creditors who are interested in making resource allocation decisions.