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Limitations of Financial Statements and Disclosure of Core Information

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Abstract: There are at least two limitations related to current financial statements that have been widely explored. First, financial statements typically only reflect the results of value creation instead of the process of value creation. Secondly, financial statements mainly reports information about tangible assets and financial assets while information about intangible assets is not fully reflected in them. With the rise of knowledge-based economy, the usefulness of financial reporting is gradually abating for lack of information about the process of value creation and intangible assets. How to increase the usefulness of financial reporting? Extant literature mainly centers on reflecting the process of value creation and intangible assets in financial statements but I believe that it is more feasible to reflect these information in off-sheet reports, therefore, in order to compensate the limitation of financial statements, an important task of disclosure is to provide sufficient information about the process of value creation and the intangible resources of enterprises which the study calls "core information". Then the study puts forward disclosure principles and disclosure framework of core information.

Key words: Financial statements, disclosure, core information

INTRODUCTION

Off-sheet reports refer to external reports of business enterprises other than the body of financial statements. In 1978, the Financial Accounting Standards Board (FASB, 1978) in the U.S. extended the concept of financial statements to the concept of financial reporting. In its SFAC No. 5, it strictly distinguished between "recognition" and "disclosure" which thus divides the financial reports into two components: Financial statements which are subject to recognition rules and off-sheet reports which are subject to disclosure rules (FASB, 1985).

Overseas literature about disclosure in off-sheet reports includes:

- Corporate report (a discussion paper) issued by ASSC (1975) and Britain (1975) which is the first effort that explains the contents of off-sheet reports in a systematic way
- Financial statements and other means of financial reporting, an exposure draft issued by FASB (1980) which explains the types and characteristics of information in off-sheet reports
- The future shape of financial reports published in Britain in 1991 which proposes that off-sheet reports should provide more forward-looking information (Bloom, 1996)
- Improving Business Reporting issued by AICPA (1997) in the US which constructs a comprehensive reporting model that consists of off-sheet reports and financial statements and represents a substantial effort that extends that the contents of off-sheet reports. Besides, Islam and Deegan (2010), Lyon and Maxwell (2011). Dhaliwal *et al.* (2011) studied the problem of disclosure of corporate environmental and social responsibility; Ball *et al.* (2012) examined the "confirmation" hypothesis that audited financial reporting and disclosure of managers' private information are complements; Beyer *et al.* (2010) review the financial reporting literature related to voluntary and mandatory firm disclosures; Files (2012) studied the problem of forthright disclosure

In China, there have been several researches on the issues concerned with off-sheet reports. For example, Ge and Du (2004) analyze the contents and characteristics of off-sheet reports and the causes of the rise of off-sheet reports. Ge and Chen (2002) put forward several proposals for the improvement of financial reports, including off-sheet reports. Chen (1998) examines some contents of off-sheet reports.

However, the above researches still insist on the financial statement perspective, according to which, financial statements are the core content of enterprise reports. Disclosure means other than financial statements are but a supplementation and an explanation of financial statements. Besides, they do not examine how to use off-sheet reports to disclose value creation process which the financial statements fail to present. With the rise of the New Economy in the 1980's, the fact that market values of companies are gradually deviated from their book values has shaken the usefulness of financial statement perspective, for example, in the last 20 years, the ratio of market capitalization to book value (i.e., market value divided by book value) of companies is rising continuously, by the end of last century, the market-to-book ratio of listed companies in the U.S. and Britain has reached to about 6 times. People start to pay attention to other means of disclosure beyond financial statements. In that way, off-sheet information sets out to play a more important role. But why can off-sheet information play a more important role? In our opinion, it is the fact that financial statements do not reflect the value creation process of the companies that gives off-sheet reports this chance.

LIMITATION OF FINANCIAL STATEMENTS AND THE ROLE OF OFF-SHEET REPORTS

The limitations of financial statements have been widely explored. A combination of the conclusions of these researches shows that there are at least two limitations related to current financial statements. First, financial statements typically only reflect the results of value creation instead of the process of value creation. In substance, the operating activities of an enterprise represent a process to earn profit through value creation. According to Kaplan and Norton (1998) this process can be briefly summarized as Fig. 1. In this process, the profit earned just represents the final result of value creation. It doesn't reflect the specific process of value creation. However, the users of external reports are not only concerned with the results of value creation of enterprises but also concerned with the process of value creation. They know that the result of value creation is merely a conclusion of the past activities but the process of value creation, though occurred in the past, reflects a trend from which the future prospect of an enterprise can be recognized when exchanges have occurred. As a result, the contribution of value creation activities to the enhancement of firm value is usually not presented in the financial statements. Secondly, financial statements

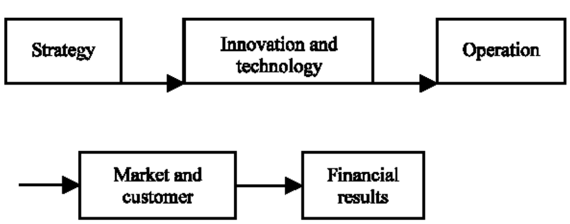

Fig. 1: Process of value creation of enterprises

forecasted. In current financial statements, the recognition and presentation of revenue, profit and other elements mainly follow the transaction perspective which emphasizes that revenues and profits should be mainly reports information about tangible assets and financial assets while information about the important asset under the New Economy, namely intangible assets, is not fully reflected in them. To be presented as an asset in traditional financial statements, an item should meet four recognition criteria: Definition, measurability, relevance and reliability. Compared with tangible assets, there are more uncertainties underlying the future benefits of intangible assets which introduces more difficulty to their measurement and even to the judgment whether they are owned or controlled by an enterprise or not. Therefore, most of the intangible assets of enterprises can not meet the four recognition criteria and thus are excluded from financial statements.

Current financial statements are the product of the era of industrial economy. The above limitations of financial statements have existed since that era. In that era, tangible assets were the main resources of enterprises and the major drive of value. With relatively short value creation cycle, the enhancement of firm value before the realization of financial results, as a result of value creation activities, was not prominent. Therefore, even in the existence of the limitations, financial statements still worked effectively. However, with the rise of the New Economy, intangible resources have become the main resources of enterprises and the major drive of value. According to several studies in the U.S., 50-90% of the firm value is created by intangible assets and only 10-50% is created by tangible assets (Dzinkowske, 2000); in 1982, about 62% of firm market capitalization is contributed by tangible resources which declined to about 38% in 1992 and further declined to less than 20% by the end of 20 century (Kaplan and Norton, 2001). The exclusion of intangible assets from financial statements has seriously reduced the importance and value relevance of financial statements. At the same time, the intangiblization of the drive of value extends the value creation cycle which means that firm value may have been significantly enhanced by value creation activities, before the final financial results have realized. Thus, the necessity of providing information about the process of value creation is increased. For the above reason, financial statements that worked effectively in the era of industrial economy start to fail in the era of New Economy. For example, I surveyed information need of institutional and individual investors, results of the survey are showed as Table 1. In my survey of the financial and non-financial performance indicators, I provided the respondents with four typical financial performance indicators which come from financial statements and five typical non-financial performance indicators which come from off-sheet reports and asked them to select some from the nine indicators that they believed were the most important performance indicateors. Table 1 shows that Both institutional and individual investors assigned more importance to financial performance indicators than non-financial ones but non-financial performance is almost as important as financial ones, especially to institutional investors, for example, although 73.1% of institutional investors believe that EPS which comes from financial statements, is one of the most important performance indicator, 69.2% of institutional investors believe quality and experience of management team which comes from off-sheet reports, is one of the most important performance indicator.

It would be difficult to change the two limitations of financial statements in a short time. First, as the transaction perspective of revenue recognition and the corresponding measurement attribute, historical cost, can not be overthrown completely, it becomes unlikely to improve financial statements in a short time to reflect the process of value creation. Second, the measurement difficulty of intangible resources makes it almost infeasible to recognize and present intangible resources in financial statements. Therefore, we believe that, in order to compensate the limitation of financial statements, an important task of off-sheet reports is to provide by various means information about the process of value creation and the intangible resources of enterprises. In this way, financial statements and off-sheet reports will compensate each other, with financial statements focusing on reflecting the performance realized as a result of exchanges with third parties and off-sheet reports focusing on reflecting the performance obtained during the process of value creation but before exchanges and on reflecting the intangible resources that are excluded from financial statements.

Disclosure about value creation process and disclosure about intangible resources are not totally separated. Actually, since the main drive of enterprise value creation is intangible resources in the new economy, the disclosure about intangible resources can be combined with the disclosure about value creation process. And the report that discloses both of them is called “Report on Value Creation Process (RVCP)”.

There have been some disclosures about value creation process scattered in current off-sheet reports. But that information is definitely not sufficient. For example, the annual reports of American companies are considered as the most “complicate” and “perfect” reports. SEC requires that Form 10-K should provide as many as 18 items. However, annual reports that follow Regulation S-K which gives requirements on the specific contents in off-sheet reports, still provide little information about the process of value creation. Off-sheet reports, except MD and A, where companies are encouraged (but not mandated) to disclose forward-looking information like operating strategies, provide little, if any, core information about the process of value creation, such as the innovation and technology ability of enterprises, the quality of operation, market and customers, etc. A survey on the high technology industry by PricewaterhouseCoopers (Eccles *et al*., 2004) finds that analysts think that they are not sufficiently informed of all of the eight off-sheet performance measures they believe important, concerned with value creation process and investors also think that they are not sufficiently informed of all of the thirteen off-sheet performance measures they believe important, concerned with value creation process. These are evidence that current enterprise reports provide insufficient information about value creation process.

We believe that the information about value creation process should be placed in a core position of off-sheet reports. Thus, we suggest that the information be provided in a special report, namely “Report on Value Creation Process (RVCP)”. That report will include all the information about value creation that currently scattered

Table 1: Financial and non-financial performance indicators considered by investors to be important

	Institutional investors (total samples: 26)		Individual investors (total samples: 134)	
Performance indicator	No.	Percentage	No.	Percentage
Earnings per share	19	73.1	102	76.1
Liquidity ratio	16	61.5	65	48.5
Growth rate of sales revenues	17	65.4	91	67.9
Asset turnover rate	15	57.7	61	45.5
Industry competition landscape	15	57.7	59	44.0
Market share and customer growth rate	17	65.4	76	56.7
Brand recognition	14	53.8	59	44.0
Quality of products and services	11	42.3	39	29.1
Quality and experience of management team	18	69.2	83	61.9

in off-sheet reports. The information will be reorganized in more systematic and logical way and any information that is currently insufficiently provided will be added. The disclosure principles and disclosure framework of RVCP will be discussed in the following sections.

DISCLOSURE PRINCIPLES OF REPORT ON VALUE CREATION PROCESS

The means of disclosure of RVCP will directly affect the decision usefulness of that information. So the disclosure should observe several principles.

First, the disclosure about value creation process should correspond to the operation model or value creation model of an enterprise. The value creation models of different industries or of different companies in the same industry may vary in some aspects. However, to ensure comparability, the disclosure of value creation process should follow some similar means and model. Since there must be some similarities in the value creation models of enterprises, we should find out the general value creation model followed by the enterprises, before we set out to disclose the value creation process.

Many scholars have studied the value creation models of enterprises. Porter (1988), Kaplan and Norton (1998), Edvinsson and Malone (1997) and Lev (2003) are some of the examples. In recent years, other scholars have also studied the issue (Esper *et al*., 2010; O'Cass and Ngo, 2010; Mustak *et al*., 2013). Borrowing the thoughts of the above scholars, we construct a general model of value creation in Fig. 2. The disclosure process discussed in the following sections is based on this general model. According to the general model, the operating strategies are affected by both macroeconomic and industrial

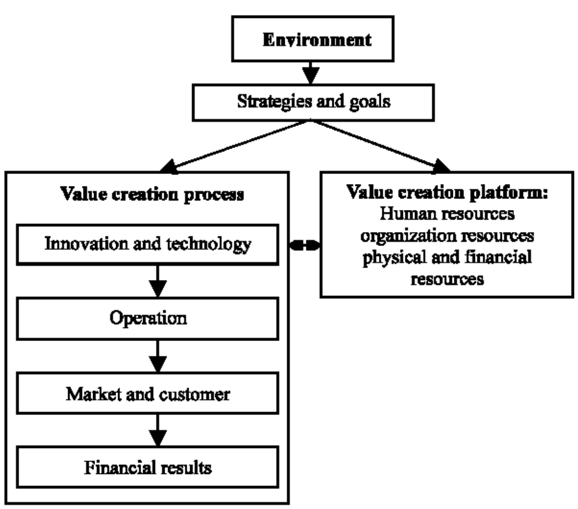

Fig. 2: General model of value creation of enterprises

environment. The strategies then determine the mode of value creation that an enterprise should adopt and the type of resources the value creation process will rely on. In the process of value creation, innovative and technical abilities will enhance the operation efficiency and effectiveness of the enterprise which then determine the quality of products or services. The quality of products or services affects the sales volume in the market. Financial results generated from the sale are the evidence whether the operation strategies have been achieved or not. The resource mix, on which the value creation process relies, is called the platform of value creation. It includes human resources, organization resources, physical resources and financial resources. It is called "platform" because it is the infrastructure of all the phases of value creation process.

Secondly, the disclosure about value creation process should be strategy oriented. The strategies and goals of an enterprise direct its value creation process. Therefore, the disclosure about value creation process should focus on explaining how the various phases of value creation process help to achieve the strategies and goals. Specifically, the disclosure about each phase of the value creation process should include (1) The relationship between the phase and the achievement of strategies (descriptive information), (2) The status quo of the phase (both descriptive information and performance measures) and (3) The challenges faced by the management and the measures to be taken (descriptive information).

Third, the disclosure about value creation process should focus on performance measures. To avoid the problem of information overload and to enable the users to understand the value creation process with as less information as possible, the disclosure of the phases of value creation process should focus on quantified financial or nonfinancial performance measures while supplemented with descriptive information. The selection of performance measures should follow several principles: (1) The performance measures should be standardized and with unified definitions and computation methods so as to ensure comparability, (2) The performance measures should be testified to be relevant (3) The performance measures should cover the whole process of value creation; and (4) The number of measures used should be controlled to make sure that the measures do not overlap but still can reflect the key drive of firm value clearly.

Fourth, the disclosure about value creation process should focus on historical information. As the value creation activities of an enterprise in the past are likely to generate financial results in the future, the information about the value creation process is forward-looking. But it does not mean that RVCP will require plenty of forecasts. Actually, an important issue concerned with off-sheet information is reliability. If RVCP is full of forecasts, the reliability of information will become worse. Accountants are not "fortunetellers". It's impossible to expect them to make accurate forecasts. So a more realistic way is to limit RVCP to mainly reflect the value creation activities that have occurred. In this way, information in RVCP will be verifiable to a large extent and thus remain reliable to a certain extent.

DISCLOSURE FRAMEWORK OF REPORT ON VALUE CREATION PROCESS

The disclosure of value creation process should correspond to the value creation model of enterprises. According to the general model developed above, the contents of RVCP and the order of disclosure are: Environment→strategies and goals→value creation platform (including human resources, organization resources, physical resources and financial resources)→value creation process (including innovation and technology→operation→market and customer→financial results).

Environment: The disclosure about environment mainly explains the important factors in macroeconomic environment, industrial environment, regulatory environment and other environment that affect the enterprises. Among these, information about industrial environment is the core content. It includes (1) General characteristics of the industry, such as the nature of the industry, the position and role of the industry in the national economy, market volume of the industry and the prospect of the industry, phase of life cycle at which the industry is, speed of technological change in the industry, market boundary of the industry, etc., and (2) Competitive structure of the industry, including the extent of competition among current companies, the threat of potential entrants, the threat of substitute products, the bargain power of buyers and the bargain power of suppliers.

Strategies and goals: The disclosure about strategies and goals contains three items (1) A statement of the strategies and goals of the enterprise, including an explanation of its long-term and short-term financial goals, (2) A statement of the rationales underlying the strategies and goals, including an explanation of which phases in the value creation process have relative advantages and of the rationale underlying the development of operating strategies and (3) A description of the actions taken to achieve the strategies and goals, including an explanation of: (a) the challenges faced by the enterprise to achieve the strategies and goals; (b) the actions that should be taken at the various phases of value creation (such as enhancing the research and development abilities, enhancing the marketing abilities, etc.); (c) the actions that have been taken and the effect achieved; (d) the actions to be taken in the future and the priority of these actions and (e) the management's plans to achieve the strategies and a comparison between prior operating performance and management's plans.

Value creation platform: Value creation platform includes human resources, organization resources, physical resources and financial resources.

First, human resources refer to the knowledge, technique, experience and talents of human beings. The human resources in an enterprise can be divided into three parts: senior managers, senior engineers and ordinary employees. A disclosure about human resources contains the following items (1) A description of how the value creation relies on human resources, with a focus on an explanation of how senior managers, senior engineers and ordinary employees play a role on the creation of firm value, (2) A statement of the status quo of the human resources, with a focus on explaining the various factors of the human resources, such as the degree of education, managing experience, organizing ability and the style of leadership of the senior managers, the innovative ability of the senior engineers, the team cooperation, fidelity and satisfaction of the ordinary employees, (3) A description of the challenges faced, i.e., the deficiencies lying in the various factors of human resources that may hinder the achievement of the strategies and (4) A description of the actions that the enterprise has taken or will take to meet the challenges.

Secondly, according to the general definition of intelligent capital, organization resources or organization capital includes process capital, company culture and innovation capital. In this study, organization resources refer to the organization elements (i.e., value creation platform) that act as the infrastructure of the various phases of value creation process. Since operating process and innovation are actually specific phases of value creation process, they will not be considered as part of organization resources. Therefore, in this study, organization resources include governance structure, organization structure, information system and company culture. The disclosure about organization resources is just the disclosure about these four elements.

The disclosure about the four elements includes three items: The status quo of each element; the deficiencies of each element that hinder the achievement of enterprise strategies; how to improve each element in the future.

Table 2: Means of disclosure for the phase of innovation and technology

Vertical information type horizontal	How is the achievement of strategies rely on innovation and technology	The status quo of innovation and technology	Challenges faced and the actions to be taken
Innovation ability	Descriptive information	Descriptive information and performance measures	Descriptive information
Technical ability	Descriptive information	Descriptive information and performance measures	Descriptive information

Third, although financial statements have given rather full disclosure about physical resources and financial resources, some additional disclosures are necessary (1) A description of the general characteristics of the major tangible assets that are important to the creation of firm value, such as the applicability, adequacy and productivity of the tangible assets, the extent to which the assets are utilized and any improvements required, (2) A statement of matters concerned with liquidity, including the current liquidity situation and whether it is proper or not, the ability of the enterprise to satisfy liquidity demand and any significant uncertainties that may affect the liquidity of the enterprise and (3) A description of capital resources, including an explanation of the significant commitments for capital expenditures made by the enterprise at the latest year end, such as the purpose of these commitments and the expected sources of fund to fulfill these commitments; an explanation of any significant known trend of capital resources (including equity capital resource, debt capital resource and off-balance-sheet financial plans), the cost of these resources and any expected significant change in the structure of these resources; and an explanation of the adequacy of financial resources to the operation of the enterprise.

Valuation creation process: The disclosure of value creation process can be done vertically and horizontally. Vertical disclosure refers to the three items of disclosure corresponding to strategies, i.e., the relationship between each value creation phase and the achievement of strategies, the status quo of each phase and the challenges faced by the management and the actions they intend to take. Contents of horizontal disclosure are different for different phases. Table 2 is an example of means of disclosure, based on the innovation and technology phase. Besides, horizontal disclosure about operation may include external supply, production process (or operation process) and quality of production (or quality of operation). Horizontal disclosure about market and customer may include the situation of market, customer and marketing efforts of the enterprise.

Some information about the realization of value that is not presented in the financial statements or in notes to financial statements should be disclosed here too. The nature of this disclosure is similar to the discussion of operating results in the Management Discussion and Analysis section. The following contents should be included (1) A description of any extraordinary items or material changes that have significantly influenced the reporting income from continuing operation and the degree of influence from each item, (2) An explanation of the reasons of any significant increase in sales revenue (for example, the rise of prices, the increase of sales volume, or the introduction of new products or services), (3) An explanation of important financial measures, (4) Comparative data and trend analysis of financial results for prior years and (5) An explanation of any difference between the financial results achieved and the original goal and the reason of the difference and an explanation of the extent to which the operating strategies are achieved as a result of the financial results realized.

CONCLUSION

RVCP has the following characteristics. First, it uses value creation as a clue to organize information into a systematic and logical framework, so that the investors can obtain a gross understanding about the process of value creation of a firm. The framework covers the disclosure about intangible assets and intelligent assets, corporate governance, organization structure, information system, environment, strategies, management discussion and analysis, etc. Though the framework includes many contents here, the contents are arranged in an order way. Therefore, RVCP overcomes the two deficiencies of traditional off-sheet reports, namely insufficient disclosure about value creation process and unsystematic disclosure of information. Second, it emphasizes historical information and thus enhances the reliability of information. Thirdly, it emphasizes that performance measures should be considered as the major information while descriptive information acts as necessary supplements, so that the problem of information overload can be abated.

However, RVCP is just an initial attempt. There are still some problems that require further study. For example, what is the general model of value creation? This is an important question because the answer to it will affect the overall structure and rationality of RVCP. Another example is performance measures. There have existed many financial and nonfinancial performance measures related to the phases of value creation. For instance, possible performance measures for innovation and technology phase include the ratio of revenue of new products to total revenue, the successful ratio of new products, product development cycle time, research leadership, number of patent, revenue of patented products, average life of patent, R and D expenditure, revenue generated from each unit of R and D expenditure, ratio of R and D expense to operating expense, ratio of R and D expense to total revenue, etc. However, among so many performance measures which are value relevant? How to define the performance measures and how to compute them? Are there any deficiencies lying in the performance measures related to each phase? What are the new performance measures that should be developed? All these are questions that worth further study.

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