

**Report by**  
**“Working Group on Corporate Disclosure”**  
**of the Financial System Council**  
**- Realizing a Virtuous Cycle in the Capital Market -**

June 28, 2018

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○ 2nd meeting (January 23, 2018)

NITTA, Takayuki	Chief Engagement Officer, Misaki Capital Inc
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○ 3rd meeting (February 21, 2018)

FERGUSON, Benjamin	Managing Director, Co-Head, Japan Securities Sales, Co-Head, Asia Pacific Equities Distribution, Securities Division, Goldman Sachs Japan Co., Ltd.
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○ 4th meeting (April 9, 2018)

DUGUID, Bruce	Director, Hermes Investment Management
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○ 5th meeting (April 23, 2018)

CALDWELL, Paul	Managing Director, Farallon Capital Management, L.L.C.
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## **Introduction**

In the midst of a drastically changing economic environment surrounding companies and investors, it is desired to realize a virtuous cycle that actualizes Japan's optimum capital flow, leading to improved corporate value and passing along the fruits to households through the fulfillment of capital market functions.

Through the provision of information that serves as the basis for investors' investment decisions, the disclosure of corporate information functions as a basic infrastructure to realize an efficient resource allocation in the capital market. It is therefore necessary to furnish sufficient, accurate, and clear information required for investment decision in a timely fashion.

From the perspective that the disclosure of corporate information in Japan substantially fulfills such a role, the Working Group conducted a comprehensive review of corporate disclosure. The Working Group's primarily focused on the disclosure in the Annual Securities Reports, paying attention to the relationship with other disclosures (Companies Act Disclosure, listing rules, voluntary disclosures, etc.), in light of the following aspects:

- 1) The pace of change in the business environment is accelerating, and management issues are growing complex and diverse along with the globalization of the Japanese companies' business activities, as well as with the development of information communication technology;
- 2) In terms of the share ownership structure in the capital market, the ownership ratio of institutional and foreign investors is rising while individual investors still occupy a key position;
- 3) Further steps have been taken to encourage efforts toward corporate governance reform and ensure credibility of accounting audit in recent years;
- 4) Efforts have been made to accelerate the improvement of disclosure, including narrative information in foreign countries such as Europe and the United States.

## I. Financial and Narrative (non-financial) Information

### 1. Basic approach

The disclosure of financial and narrative information<sup>1</sup> enables investors to make appropriate investment decisions and is important from the perspective that companies improve management quality and enhance corporate value continuously by promoting constructive dialogue between investors and companies<sup>2</sup>.

As narrative information is necessary to understand companies' financial conditions and their changes as well as their business outcome, it is considered to be important to (1) provide a narrative explanation of a company's financial statements that enables investors to see the company through the eyes of management, (2) enhance the overall financial disclosure and provide the context within which financial information should be analyzed, and (3) provide information about the quality of, and potential variability of, a company's earnings and cash flow, so that investors can ascertain the likelihood that past performance is indicative of future performance<sup>3,4</sup>. Therefore, it is key to appropriately disclose narrative information that is regarded as necessary for investment decisions in the Annual Securities Reports<sup>5</sup>.

As the enrichment of narrative information deepens investors' understanding of companies, it is expected that the dialogue between investors and companies toward the enhancement of mid- to long-term corporate value becomes more effective, bringing about "awareness" to companies<sup>6</sup>.

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<sup>1</sup> "Financial information" means information provided in "Documents on Financial Calculation" under Article 193-2 of the Financial Instruments and Exchange Act. "Narrative (non-financial) information" generally refers to information other than financial information provided in the disclosure documents.

<sup>2</sup> An opinion has been voiced that while the disclosure of narrative (non-financial) information aims at deepening investors' understanding of companies, the provision of necessary and sufficient information to assess mid- to long-term corporate value would be particularly important.

<sup>3</sup> U.S. Securities and Exchange Commission Guidance ("Interpretation: Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operation" (December 2003))

<sup>4</sup> It was also pointed out that while the importance of intangible assets, which become the source of long-term value creation of companies, is increasing, it is necessary to understand them through narrative information because such value is difficult to measure financially and may not always be reflected in the financial information.

<sup>5</sup> As the idea of enriching narrative information is spreading internationally, such as the promotion of so-called the Integrated Report, some indicate that Japan should also reflect such an idea in the Annual Securities Reports.

<sup>6</sup> It was noted that in addition to proceeding with necessary improvement to mandatory disclosure, it would be important that each company provides information and explores themes that should be appealed on its own accord in voluntary disclosure as a supplement to mandatory disclosure from the following perspectives:

- Deepening investors' understanding of companies
- Accumulating voluntary disclosure and leading to the improvement of mid- to long-term mandatory disclosure

## 2. Business Strategy and Business Model

In the last Working Group Report<sup>7</sup>, “Business Policy” traditionally stated in Earnings Releases was perceived to be appropriate to be included in the Annual Securities Report, as it would be a valuable piece of information in determining whether a given company matches the intent behind an investor's mid- to long-term investments.

In response to this view, the disclosure of business policies and business strategies became mandatory in the Annual Securities Reports from the business year ending after 31 March, 2017<sup>8</sup>.

However, it is still pointed out that, on the whole, there is a substantial number of Japanese companies not describing specific mid- to long-term corporate visions enough and/or not relating them to Management's Discussion and Analysis of Financial Condition, Results of Operations and Cash Flows” (“MD&A”) and risk factors.

In the United Kingdom, the Companies Act 2006 obliged companies to prepare “Strategic Reports” as part of their annual reports in 2013. In 2014, the Financial Reporting Council issued Guidance on the Strategic Report. The Guidance indicates that a Strategic Report should reflect the collective view of directors and consist of information which is material for investors; strategic management (strategies and objectives, and business models), business environment (principal risks, etc.) and business performance (Key Performance Indicators (KPIs), etc.) should be described interrelatedly.

Business strategies are regarded as a plan or approach intended to help companies achieve their objectives<sup>9</sup> and provide insights into their development, performance, position and future prospects. The description of companies’ strategy and objectives should focus on the high priorities related to their development, performance, position and future prospects.

Furthermore, in terms of business models, companies are required to describe how they generate or preserve value over the longer term<sup>10</sup> and how they capture that value. For this purpose, companies should clarify what makes them different from, or the basis on which they compete with, their peers, and provide how companies are structured, the markets in which they operate, and how they engage with those markets (e.g. what part of the value chain they operate in, their main products, services, customers and their distribution methods), as well as the nature of the relationships with stakeholders, resources and other inputs that are necessary for the success of the business.

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<sup>7</sup> “Report by Working Group on Corporate Disclosure of the Financial System Council - Promoting Constructive Dialogue” (April 2016)

<sup>8</sup> If companies have developed business policies and business strategies (management philosophy, business models and business plans, etc.), the content should be described. If there are any objective indicators (Key Performance Indicators, KPIs) that determine the degree of achievement of management objectives, the content should be stated. Furthermore, the content and responses should be described specifically with regard to the business environment as well as business/financial issues to be dealt with.

<sup>9</sup> The United Kingdom Financial Reporting Council Guidance (“Guidance on the Strategic Report” (June 2014)) describes it as “A plan or approach that is intended to help the entity achieve an objective.”

<sup>10</sup> The United Kingdom Financial Reporting Council Guidance (same as above) describes it as “How the entity generates or preserves value over the longer term.”

In Japan, directors and management are required to actively commit themselves and present their perspectives on their companies' objectives and business strategies, and business models in disclosing business policies, business environment and issues to be dealt with. Furthermore, companies should provide a more specific and fulfilling explanation by clearly indicating the achievement of business strategies and future issues and associating them with MD&A, KPIs and risk factors so that investors can understand appropriately.

Specifically, with regard to objectives and business strategies, considering the disclosure practice in the United Kingdom as mentioned above, companies should specify their business plans/policies by associating them with corporate structures and markets in which they operate and relationships with markets. Companies should also provide information that helps in assessing the appropriateness of business strategies to achieve their objectives and in assessing growth, business results, financial conditions and future prospects.

Similarly, regarding business models, companies should clarify how they operate and create value in the mid- to long-term; companies should explain this by associating with corporate objectives and business strategies so that investors can assess the appropriateness of business strategies and feasibility.

### **3. Management's Discussion and Analysis of Financial Condition, Results of Operations and Cash Flows (“MD&A”)**

In January of this year, the Cabinet Office Ordinance was amended to include the following requirements in the description of Management's Discussion and Analysis of Financial Condition, Results of Operation and Cash Flows (“MD&A”), in response to the issues raised in the last Working Group Report (e.g. lack of thorough analysis and discussion through the eyes of management, etc.)<sup>11</sup>:

- Management-level view and analysis regarding factors that materially affected operating results;
- How management analyzes and evaluates operating results in view of mid- to long-term targets, such as business policies and strategies

While such development is in progress, it is considered that Japanese companies make further efforts to enhance the disclosure of MD&A on the whole; it has been noted that there are many cases, in comparison with other countries, where companies just convert numerical information to narrative information or provide boilerplate description.

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<sup>11</sup> With respect to “Overview of Operating Results” and “Overview of Production, Orders Received and Sales,” which were integrated into MD&A based on the last Working Group Report, it was also pointed out that there were cases where the content of “Overview of Operating Results” was not an analysis but merely a summary of financial information, and matters to pay special attention to were not stated sufficiently.



In this respect, in the United States, the SEC Regulation requires companies to explain operating results of the entire business as well as each business segment, prospective expenditure and sources of financing of cash and capital, business environment, off-balance sheet arrangements and contractual obligations in the MD&A; it is also required by the SEC Guidance<sup>12</sup> to provide explanations for critical accounting estimates and assumptions. On that basis, it is recommended that companies provide information to understand financial information from managements' perspectives and offer context for analyses. At the same time, to contribute towards the objectives of MD&A, which enables investors to ascertain the likelihood that past performance is indicative of future performance, companies are encouraged to involve top-level management at the early stage in identifying the key disclosure themes and items that should be included in MD&A. Moreover, companies are encouraged to analyze and discuss known material trends, events, demands, commitments, and uncertainties, including the underlying reasons or implications, interrelationships between constituent elements, or the relative significance of those matters. Companies should not just descriptively state financial information; financial condition and operating performance should be analyzed on a consolidated basis, with segment data provided where material to an understanding of the financial condition and operating performance.

In the United Kingdom, based on the Companies Act 2006, companies are obliged to describe their analyses of operating results and financial conditions and explain KPIs in the Strategic Reports. Furthermore, the FRC Guidance indicates that these analyses are to supplement financial information and requires companies to analyze operating results in accordance with their strategies. Segmentation of the analysis should be consistent with the segments identified in the financial statements. The Guidance also requires companies to analyze factors that may impact future cash flows by relating them to the current cash flow, explaining liquidity and financing capabilities, and providing information on companies' key strengths and tangible/intangible resources which are not always reflected in the financial statements, such as corporate reputations and brand strengths, customer bases, employees, research and development, and intellectual property.

On the other hand, the disclosure of MD&A in Japan still does not contain enough analyses from the management perspective. It is also pointed out that there are cases where the classification of business segment in MD&A is different from the ones used by management. Analyses and disclosure of business segments were identified to be important from the viewpoints of streamlining a business portfolio that has been raised in the context of corporate governance reform as well as improving capital efficiency.

Some commented that information on capital resources and cash flows would be critical to assess companies' awareness of capital costs and financial management, and therefore the enhanced

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<sup>12</sup> U.S. Securities and Exchange Commission Guidance ("Interpretation: Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operation" (December 2003))

disclosure of such information should be desired.

With respect to the disclosure of critical accounting estimates and assumptions, an opinion was voiced that an improved disclosure would be desirable with management involvement in light of its significance in making management decisions and risks of estimated factors bringing about unexpected impacts on companies' operating results.

MD&A is important for (1) providing a narrative explanation of a company's financial statements that enables investors to see the company through the eyes of management, (2) enhancing the overall financial disclosure and providing the context within which financial information should be analyzed, and (3) providing information about the quality of, and potential variability of, a company's earnings and cash flow, so that investors can ascertain the likelihood that past performance is indicative of future performance. For example, investors can learn managements' views on the balance of growth investment, cash reserves and shareholder returns as well as the companies' awareness of capital costs from the information regarding capital resources and cash flows included in MD&A.

Consequently, since MD&A provides information from managements' perspectives, which is closely connected to the way of running business as well as management's awareness and deepens investors' understandings of companies, top-level managements should be involved from early stages and fulfill accountability as managements.

For analyses of segments, the analyses should be based on the same segment as that of management control, and they should provide information that enables investors to understand the status of segments more clearly, including the capital efficiency of each segment<sup>13, 14</sup>.

With respect to information on capital resources and cash flows, which are essential for investment decisions, the following information should be disclosed more effectively: from where and how capital and cash are funded; and how the funded capital and cash will be allocated to capital investment and R&D (research and development) in executing business strategies.

Similarly, since accounting estimates and assumptions are directly linked to investment decisions and management decisions, a better disclosure should be provided with the involvement of management.

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<sup>13</sup> When the disclosure of separate financial statements was simplified in accordance with the revised Regulation on Financial Statements in 2014, companies were supposed to improve segment information in the consolidated financial statements and disclose the content of the notes as non-financial information to address concerns about the information of the separate financial statements being reduced. For example, companies would not be required to disclose detailed statements of the cost of goods manufactured as long as they state segment information in the notes in the consolidated financial statements. However, with respect to the subsequent development of segment information disclosure, it has been pointed out that, in some companies, there are cases where segment classifications are different from the classifications used for management control, or the disclosed content is not enough to analyze profitability.

<sup>14</sup> Furthermore, it was indicated that in Japan the classification of segments should be analyzed and considered in efforts to realize more appropriate disclosure, as the US SEC's review emphasizes appropriate disclosure of segment information in MD&A.

#### 4. Risk factors

The current disclosure system of risk factors has been implemented since March 2003. Among the matters related to “Contents of Business” and “Status of Accounting,” companies are required to collectively state matters that may have material impacts on investors’ decisions<sup>15</sup> specifically, clearly and concisely.

However, on the whole, it has been pointed out that from the disclosure of risk factors by Japanese companies alone, it is difficult to understand risks that may impact investment decisions. There are many cases where companies only give a list of general risks, the disclosed information remain unchanged for several years even though the external environment has changed, or relationships of risks to business strategies and MD&A are unclear. In addition, an opinion was voiced that the disclosure of company-specific risks, the levels of impact when the risks realize and measures to respond to the risks would be important for investment decisions.

In the United Kingdom, based on the Companies Act 2006, companies are obliged to explain the principal risks and uncertainties they face in the Strategic Reports. In the FRC’s Guidance, it is required to state the measures to be taken to principal risks and uncertainties, changes to the levels of risks and relevance to strategies. Risk information includes both financial and non-financial characteristics and should be limited to risks that managements regard as material in terms of the companies’ growth, performance, financial conditions and future prospects from the aspect of the probabilities of risk occurrence and the magnitude of potential impact on companies. When stating a general risk that is not company-specific, it is required to clarify the potential impact on the company specifically.

By referring to the disclosure practice employed in the United Kingdom, a more effective disclosure of risk factors should be promoted in Japan. An improved disclosure of risk factors should be according to company-specific circumstances, including the probabilities and timing of occurrence, impacts on business, and measures to respond to risks; these should be stated in the order of the significance of risks from management’s perspective.

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<sup>15</sup> Such matters include: extraordinary behavior of financial conditions, operating results and cash flow status, dependence on particular clients, products and technologies, specific legal regulations, trade practice and business policies, and occurrence of important lawsuits and important matters relating to board members, major shareholders and affiliates (Points in Attention Concerning Preparation of Document regarding Cabinet Office Ordinance on the Disclosure of Corporate Affairs, etc.)

## **5. Other matters**

### **(1) Personnel information**

For personnel information, the current disclosure rules require companies to state the number of employees on a consolidated basis by segment, headcounts, average age, length of service and annual salary (including bonuses) of employees of a reporting company. If there are any matters with labor unions to be specified, then the relevant information should also be reported in the disclosure.

At the Working Group, it was commented that improving information on employees,<sup>16</sup> such as gender diversity, working environment, and overall labor costs on a consolidated basis, would be important from the standpoint of measuring productivity in considering the way of working. It was also pointed out that when a reporting company is a holding company, it would be generally helpful if such company states information about the employees of the major corporates.

In recent years, there has been a growing interest in the above personnel information and the so-called ESG information in response to companies' initiatives to strengthen corporate governance as well as an increasing interest toward social and environmental issues. It is viewed that each company should disclose better information appropriately via statutory/voluntary disclosure as needed in investment decisions and dialogue<sup>17</sup>.

### **(2) Material contracts**

Currently, if companies have material contracts, it is required to state the outline of the contracts in the Annual Securities Reports. In the United States, a detailed disclosure of certain material contracts<sup>18</sup> with attachment of the contract documents is required. In these circumstances, some investors pointed out that, with respect to contracts they think of as material for investment decisions and engagements with Japanese companies, there are cases where a company in the United States, as the other party of the contract, is disclosing the content of the contract, yet there is no disclosure

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<sup>16</sup> Information on employees includes information about human resources management and occupational health and safety.

<sup>17</sup> In the Annual Securities Reports, it is required to state matters that are necessary and appropriate for the public interest or investor protection. In addition to matters required to be stated specifically, if matters relating to governance and social/environmental issues (so-called ESG factors) have material impacts on issuers' business and/or operating results, it is obliged to disclose them in the items "Business Policy and Business Environment Issues To Address, etc.," "MD&A" and "Business-related Risks, etc." of the Annual Securities Reports.

<sup>18</sup> In the United States, companies are obliged to attach written documents stating the content of contracts for all material contracts which are not made in the ordinary course of business (Regulation S-K Item 601(b)(10)(i)).

from the Japanese company.

While understanding the current status overseas, it is expected to promote each company to make an appropriate disclosure of the content of contracts that are considered to be material for investors' investment decisions and engagement<sup>19</sup>.

### **(3) Clear disclosure**

While increasing the direct/indirect holding of shares by individual investors is said to be important from the standpoint of promoting people's stable asset building, making a concise and clear disclosure with expressions that are also easily understandable to individual investors is critical. However, it is pointed out that statements in the Annual Securities Report of each company are hard to understand for individual investors. From the perspective of promoting constructive dialogue between companies and investors<sup>20</sup>, it is expected to contrive the style of expression of disclosure documents so that the improvements in disclosure of non-financial information does not result in a lengthy list of information.

With respect to the style of such clear disclosure, in the United States, the SEC adopts the concept of "Plain English" for certain non-financial information (information relating to risks and governance, etc.), which recommends that statements should be structured clearly, concisely and methodologically using plain words. In the United Kingdom, the FRC published "Clear & Concise" in 2015 for the purpose of providing investors with appropriate and understandable information without difficulty. While indicating actual examples of good disclosure, it also illustrates some elements to achieve such disclosure, including focus on material information, internal cooperation among different departments and management involvement from an early stage.

Referring to such actions taken in other countries, further efforts should be made in Japan to encourage each company to provide sufficient, accurate and understandable information material to investors in a timely fashion<sup>21</sup>.

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<sup>19</sup> Should the content of material contracts have significant impact on companies' operating results, the disclosure of such content is required, including the impact on profit and loss. There were views that a more open disclosure would be required for cases like business tie-up contracts, which include matters that significantly impact the governance of the company concerned.

<sup>20</sup> Moreover, it is pointed out that each company is adopting a different style of expression in accordance with the roles of the Annual Securities Report and the Business Report. In standardizing or unifying both documents, each company should consider what kind of expression would be understandable for investors and shareholders, including individual investors and shareholders.

<sup>21</sup> It was commented that including charts in narrative information and clearly stating changes from the previous year in the Annual Securities Reports as needed would be effective for clear disclosure.

## 6. For improvement of financial and narrative information

As long as top management has clear views on business strategies, financial conditions, risks and governance, it is possible to make a fulfilling disclosure reflecting those views. Such disclosure is expected to create a virtuous cycle, facilitating appropriate investment by investors, further deepening constructive dialogue with investors and establishing better business strategies through the dialogue<sup>22</sup>.

However, it has also been pointed out that it is doubtful whether at some Japanese companies business strategies, financial conditions or risks are even adequately discussed in the first place. Without having clear ideas on these issues, companies cannot take active disclosure attitudes and the disclosure will inevitably become superficial and boilerplate, just responding to the rules. Such companies may cause issues with their sustainability, which could lead to a situation where they become excluded from investment by mid- to long-term investors, or even targeted by short-term investors just tracking the companies' price fluctuations without standing on corporate analyses, which may end up arousing distrust of investors.

It is important to promote companies discussing their own business strategies, financial conditions and risks and improve disclosure of narrative information among the Japanese companies, including business strategies and business models, MD&A, risk factors, material contracts, and governance, etc. For this purpose, a rule that not only specifically sets the content of disclosure, such as mentioned above, but also a principle-based guidance, which enumerates the desirable approaches, contents and practices derived from best disclosure practices, should be developed to facilitate companies' efforts to enhance disclosure as more than just a formal response to the rules.

With respect to the disclosure of narrative information, since the way in which directors and management perceive the content and concept of disclosure is essential, it is important that top management gets involved in the content of disclosure in a responsible way from early stages and that board of directors deliberate disclosure policies thoroughly.

In the United Kingdom, the Strategic Report is characterized as providing stakeholders with information to assess how the directors have performed their duty,<sup>23</sup> and it is required to reflect the

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<sup>22</sup> In recent years, many companies are disclosing additional non-financial information in the form of Integrated Reports and Environmental Reports (voluntary disclosure) to respond to the needs for various information from stakeholders such as investors. Although the ideas of mandatory disclosure and voluntary disclosure were described in the last Working Group Report, "III. Enhancing disclosure of non-financial information," it was commented that enhancing mandatory disclosure would be important in light of the fact that negative information like risk factors is not necessarily provided in voluntary disclosure.

<sup>23</sup> Under Section 172 of UK Companies Act 2006, a director is required to promote the success of the company for the benefit of its members as a whole.

collective view of the company's directors to contribute to the assessment<sup>24</sup>. Furthermore, the Strategic Reports must be approved by the board of directors and signed by directors on behalf of the board of directors<sup>25</sup>. Also in the United States, early top-level involvement by a company's management is encouraged in identifying the key disclosure themes and items<sup>26</sup>.

The UK FRC established the Financial Reporting Lab in 2011 to provide an environment where investors and companies can come together to develop solutions to further enhance the disclosure of corporate information<sup>27,28</sup>.

In seeking to improve the content of disclosure in Japan, it is expected to make efforts to build-up appropriate disclosure practice, in addition to preparing rules and principles-based guidance on disclosure<sup>29</sup>. From this perspective, it is necessary to improve the level of disclosure on the whole by undertaking efforts to spread the best practices of some companies as well as reflecting such best practices in guidance, if needed. Based on the accumulation and spread of the best practices and preparation of the guidance, establishing a virtuous cycle where interaction between stakeholders and companies improves disclosure continuously.

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<sup>24</sup> UK FRC Guidance (Paragraph 4.1 and 4.2 of "Guidance on the Strategic Report" (June 2014)).

<sup>25</sup> Section 414D, UK Companies Act 2006

<sup>26</sup> U.S. Securities and Exchange Commission Guidance ("B. Approach to "MD&A" in "Interpretation: Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operation" (December 2003)).

<sup>27</sup> Examples of the activities of Financial Reporting Lab include "Lab project report: Business model reporting" (October 2016) and "Lab project report: Risk and viability reporting" (November 2017).

<sup>28</sup> In the United States, the improvement of disclosure has been facilitated by the SEC's review on disclosure documents and the feedback process based on the review.

<sup>29</sup> The US SEC is conducting a deep-dive review on MD&A and risk factors, attempting to enhance the level of disclosure. An opinion was voiced that such efforts should be made in Japan as well.

## II. Disclosing corporate governance information to promote constructive dialogue

### 1. Basic approach

As the Japanese government is undertaking a reform of corporate governance from the perspective of strengthening the function of the capital market and realizing people's stable asset building, the Japanese government revised the Stewardship Code in May 2017, and published a revised Corporate Governance Code and established the "Guidelines for Investor and Company Engagement" in June 2018.

In reaction to such efforts, it is required to provide a more fulfilling governance information and improve the way of providing it from the viewpoint of promoting more constructive and effective dialogue between investors and companies.

### 2. Information regarding management's remuneration

In recent years, more companies are introducing performance-linked remuneration to create incentives for management to improve corporate value<sup>30</sup>. Whether remuneration structures sufficiently function as appropriate incentives for management to improve corporate value is emphasized in investment decisions and dialogue as one of the factors determining companies' mid-to long-term growth expectation.

The current disclosure rules in Japan require disclosing the following information in respect of management's remuneration:

- Policies on the decision of the amount or the calculation method of officers' remuneration of the reporting company;
- Total remuneration by officers' classification;
- Total amount by the type of remuneration;
- Number of officers concerned;
- Total amount of officers' remuneration of the reporting company and its consolidated subsidiaries if receiving more than or equal to 100 million yen on a consolidated basis and the amount by the type of remuneration;

On the other hand, the following points were raised in terms of the current disclosure of officers' remuneration of the Japanese companies;

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<sup>30</sup> As of the end of June 2017, the number of listed companies introducing performance-linked remuneration increased by approximately 30% compared with the same month a year ago, which means that one in almost three listed companies are introducing the system ("Stock-based compensation implementation status" (August 2017) by Willis Towers Watson and Mitsubishi UFJ Trust and Banking).



- The basic content of remuneration programs, including the ratio of fixed and performance-linked remuneration and the determinants of the amount of performance-linked remuneration, are hard to understand;
- The link between the level of achievement of business strategies and remuneration including the KPIs for determining remuneration, which is necessary to infer the likelihood of the achievement, is not sufficiently explained;
- It is doubtful whether the disclosure of officers receiving more than or equal to 100 million yen of total consolidated remuneration meets the expectation in corporate governance that fair remuneration should be provided to management who has contributed to improve corporate value.

In the United Kingdom, based on the Companies Act 2006, companies explain the content of remuneration programs, calculation methods for each type of remuneration and reflection of the resolution at general shareholders meetings in respect of the remuneration of all directors and disclose a list of remuneration for each individual in the last two years. For remuneration of executive directors, the possible maximum amount based on the remuneration program is disclosed. In addition, remuneration amount of CEO over the last ten years and the total shareholder return over the same period<sup>31</sup> are disclosed for comparison.

In the United States, under the SEC regulation, in addition to the content of remuneration programs, calculation methods of each type of remuneration and reflection of resolution at general shareholders meetings, a list of individual remuneration over the last three years of CEO, CFO and three executive officers receiving the highest remuneration is disclosed as well as the individual remuneration for all directors. In addition, total shareholder return, which is obligated to disclose, is widely used as an evaluation indicator for determining officers' remuneration in practice.

To be able to evaluate the link between managements' remuneration content/program, and business strategies and mid- to long-term corporate value improvement, companies should be required to specifically and clearly state the decisions and payment methods of remuneration as well as policies regarding them, including calculation methods of fixed remuneration, short-term performance-linked remuneration (bonus) and mid- to long-term performance-linked remuneration (stock options, etc.), payment ratio of fixed remuneration and short-term and mid- to long-term performance-linked remuneration and policies on the remuneration amount by each position if applicable<sup>32</sup>. Furthermore, if indicators such as KPIs are related to calculation methods of officers'

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<sup>31</sup> Total shareholder return (a ratio of return from equity investment (dividend and capital gain) divided by investment amount (share price))

<sup>32</sup> In respect of salaries for important employees who double as officer and employee, since it is required to disclose them together with officers' remuneration in the Annual Securities Reports, it is considered that this point should be also considered in the disclosure of remuneration program.

remuneration, such indicators should be stated together with the reasons for selecting them, methods to reflect in performance-linked remuneration and the date of general shareholders meeting that passed the resolution for the total remuneration amount.

Furthermore, to assess whether the actual remuneration is consistent with the remuneration program and functioning as incentives for management, the followings should be disclosed like disclosures overseas in respect of the actual remuneration based on the remuneration program while linking it to total shareholder return: reasons for determining the remuneration amount in the current term, the target KPIs of the current term and the actual level of achievement, the actual payment ratio of fixed and performance-linked remuneration for the current term if it is not predefined and the remuneration status paid out for each position.

In addition, to be able to assess the objectivity and transparency of the remuneration decision process, the decision makers of calculation methods, their authority and discretion, information about the function and members of remuneration committees if any should be disclosed. In addition, the disclosure of specific activities of boards of directors and remuneration committees should be required so that the effectiveness of the remuneration decision process can be confirmed.

Since it is doubtful whether the disclosure of officers receiving more than or equal to 100 million yen of total consolidated remuneration meets the expectation in corporate governance that fair remuneration should be provided to management who has contributed to improve corporate value, there is a room to reconsider in this respect. In revising the disclosure requirements regarding individual remuneration, it was commented that, in terms of verifying the appropriateness of remuneration, it would be more beneficial to seek the disclosure based on responsibilities such as of CEOs and presidents or for some of the highest-remunerated people irrespective of amount, rather than delimiting them based on the level of remuneration. On the other hand, there were also views that expanding the scope of individual disclosure would not be necessarily important as the level of officers' remuneration in Japan is low compared to that of other countries and the appropriateness of remuneration can be verified if the disclosure of the content and policies for determining remuneration are improved<sup>33</sup>.

Therefore, the disclosure of officers' remuneration programs should be enhanced first and then, the individual disclosure should be reconsidered as necessary in light of the progress of verifying the consistency between the remuneration and business strategies and the change in the level of officers' remuneration in Japan.

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<sup>33</sup> Furthermore, it was also pointed out that individual disclosure of officers' remuneration would raise privacy concerns.

### 3. Cross-holding shares

Under the current disclosure requirements since 2011, in respect of cross-holding shares (listed shares held for the purpose of non-investment) exceeding 1% of capital (if the number of such shares is below 30, the top 30 shares by holding amount), companies are required to state the names, the number of shares held, balance sheet amount and holding purpose for each share in the Annual Securities Reports.

Information on cross-shareholdings is considered to be important for both investment decisions and dialogue because while some view that cross-shareholdings are meaningful for promoting strategic partnerships between companies, others view that the existence of stable shareholders may loosen discipline of business management and capital efficiency is low due to the lack of verification of the benefit of such holding.

In view of the current state of the disclosure of cross-shareholdings, it was pointed out that the rationality and benefit of holding cannot be verified as the explanation of holding purpose is only stated in a boilerplate and abstract fashion. There were a number of opinions, particularly from investors, requesting for a detailed disclosure on the holding purpose, benefit and rationality because cross-shareholdings do not necessarily lead to mid- to long-term corporate value improvement, but rather have high risks of neglecting minority shareholders as well as lowering awareness of capital cost.

While there are various views about the objective and benefit of cross-shareholdings, the policies, purpose and benefit of cross-shareholdings should be explained specifically and sufficiently as long as companies hold shares by taking risks and spending capital costs<sup>34</sup>. In addition, the disclosure of the methods to verify the rationality of holding cross-holding shares as well as the discussion in boards of directors should be requested.

Furthermore, it should be required that holding purposes and benefits of individual cross-holding shares are related to strategies, business content and segments of the reporting company and stated specifically including the quantitative effects (if it is not possible to state quantitative effects, the reason and the verification method of the rationality of holding should be stated).

In addition, there were views that;

- Holding purposes of cross-holding shares whose number of shares and amount held are small cannot be confirmed because these shares are not subject to disclosure as cross-holding shares although the advantages that may lead to strategic partnerships between companies are

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<sup>34</sup> For explanation, it is considered that it should be stated in relation to material contracts and information about related parties in the Annual Securities Reports.

relatively minor;

- For cases where the disclosed shares vary due to the fluctuation of market values, it is not possible to grasp the status of change each year;
- There are cases where shareholdings which are considered to be held for cross-shareholdings are classified as pure investment;
- In 2014, it was no longer required to include a schedule of securities showing the holding status of equities, bonds and other securities. As the coverage of disclosure of individual shares was then limited to cross-holding shares only, it is now difficult to grasp the financial risk of a company with fewer information about equities, bonds and other securities holding as pure investment;
- It is desired that information about equities, bonds and other securities with investment purpose, not just cross-shareholdings, be disclosed from the perspective of verifying the appropriateness of capital allocation and efficiency

Based on the above views and the rising interests of investors on the management's awareness of capital efficiency along with the progress of corporate governance reform, the following disclosures should be improved:

- In respect of the cross-holding shares sold or bought, including the shares below the disclosure threshold, the number of cross-holding shares sold/bought, total amount of shares sold/bought and the reasons for adding to holdings;
- The number of shares subject to disclosure based on the views that it should be increased<sup>35</sup>;
- A clear explanation of the criteria and concept of the classification between pure investment and cross-shareholdings as it is pointed out that there are cases where the shareholdings which are considered to be held for cross-shareholdings are classified as pure investment;
- A certain disclosure of shares held for pure investment, in light of their importance.

Furthermore, in making an investment decision, there were opinions that as well as verifying the status of cross-shareholdings of a company as an investment destination, it would be necessary to verify the status of the shares of the company as an investment destination being held by shareholders for cross-shareholdings. If a reporting company holds shares of the other company as cross-shareholdings and the other party is a shareholder of the reporting company, the shares held by the other party should be required to make a statement with attention to practical burden.

In respect of the content of the exercise of voting rights of cross-holding shares, while some viewed that it should be disclosed because it would be an important information in judging whether

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<sup>35</sup> In respect of the number of shares subject to disclosure, it is considered that it should be examined based on the fact that the median of the number of cross-holding shares of Nikkei 500 companies is 63.0 ("Comparison of cross-shareholdings in 2015 and 2016," *Bessatsu Shojihomu* (Annex of Business Law Journal) No.417 (no English translation)).

the benefit of cross-shareholdings is achieved, others viewed the disclosure would be rarely useful because it is inferred the majority would approve the company's proposal from the standpoint of holding cross-holding shares and thus introduction of such disclosure should be carefully examined.

#### **4. For improvement and provision of other governance information**

At present, in respect of information on corporate governance, corporate governance structure, status of cross-shareholdings and backgrounds of officers are disclosed in the Annual Securities Reports under the Financial Instruments and Exchange Act while responses to the Corporate Governance Code are disclosed in the Corporate Governance Reports under the regulations of a stock exchange<sup>36</sup>.

It is important to provide investors with governance information clearly in facilitating appropriate assessment of corporate value and constructive dialogue between investors and companies. Governance information necessary for investment decisions needs to be disclosed appropriately in the Annual Securities Reports and is presumed to be supplemented by governance information stated in the Corporate Governance Reports. On the basis of such perspectives, the followings are considered as necessary:

- To improve and organize governance information in the Annual Securities Reports and Corporate Governance Reports respectively;
- To organize the stated information across the Annual Securities Reports and Corporate Governance Reports

In terms of improving and organizing information in the Annual Securities Report, it is necessary to enhance the comprehensiveness of governance information. In addition, it was pointed out that "Summary" concerning corporate governance framework (including committees established voluntarily) should include statements of specific activities of the board of directors and committees.

In light of the above, although "Information about changes in directors (and other officers)" and "Information about corporate governance, etc." are separate items, they should be organized within "Information about corporate governance, etc." from the perspective of enhancing the comprehensiveness of governance information.

From the perspective of improving governance information, in the "Summary" concerning corporate governance framework, structures of boards of directors and committees (including names, headcounts, members, distinction between inside and outside officers and attribute of Chairman, etc.) and the purpose of establishment and authority of the committee should be stated in accordance

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<sup>36</sup> Some information (biographies of officers and information about individual cross-holding shares, etc.) is only disclosed in the Annual Securities Reports.

with the institutional design of the reporting company.

Furthermore, in terms of activities of boards of directors and committees, etc. including the content of discussion, while activities should be stated specifically, the following points are considered:

- Activities for Kansayaku Boards (Audit & Supervisory Boards) should be stated in the Annual Securities Reports to assess their effectiveness (please refer to “III.1. Information about accounting and auditing”);
- For boards of directors and committees, (excluding boards of auditors and auditing committees), since they may vary among companies, improvement in the statements of Corporate Governance Reports<sup>37</sup> should be promoted firstly

In respect of organizing stated information between the documents, there were views from investors that the characteristics of each document should be considered, such as the degree of importance and reliability of the Annual Securities Reports and the degree of fullness and frequency of update as well as the convenience including the useful search function of the Corporate Governance Reports.

Moreover, some other comments were made on the Corporate Governance Reports mainly from the users that there were cases where the referred information was either out of date or deleted and the comprehensiveness of the document may be lost if there were too many references while transcribing information is presumed to be straightforward. On the other hand, mainly from the preparers, it was pointed out that references should be allowed as much as possible because duplicating statements would be time-consuming.

While there are various opinions about organizing statements in both documents, it is expected that an exchange of views between investors and companies will be conducted in regard to the desirable provision of information in light of the characteristics of both documents, and that efforts to improve disclosure will be sought accordingly.

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<sup>37</sup> It was pointed out that activities of boards of directors and committees are important to judge whether they are functioning effectively and should be requested to be stated in the Annual Securities Reports as well as the Corporate Governance Reports.

### **III. Assurance of reliability and timeliness of information**

#### **1. Information on accounting audit**

Information on accounting audit is important not only for judgment on appointment and dismissal of an auditor by shareholders but also from the standpoint of assuring reliability of financial information that is fundamental to investment decisions, and such information needs to be provided to investors sufficiently in an easily comprehensible manner.

From this aspect, the “Advisory Council on the Systems of Accounting and Auditing” in March 2016 recommended the enhancement of disclosure of information including:

- what kind of efforts companies make to ensure appropriate audits in collaboration with their auditors;
- how the Kansayaku Boards (Audit & Supervisory Boards) assess the auditor.

In addition, the council also recommended that the “period during which the auditor has been engaged in audits of the entity” that is necessary for assessment of independence of the auditor should be provided in the Annual Securities Reports.

In this regard, in the United States, the policy and reasons for appointment and dismissal (including assessment of audit) as well as the policy and procedures for prior approval by the audit committee for audit and non-audit services, fee amount and outline of services for audit and non-audit contracts with the entire network to which the auditor belongs (hereinafter referred to as “network-based fee amount and outline of services”) and other information are disclosed in a proposal for appointment of an auditor in accordance with the SEC rules. Furthermore, the auditor tenure is disclosed in an auditor's report in accordance with the auditing standards.

In the United Kingdom, network-based fee amount and outline of services, effectiveness assessment of the audit process, procedures for appointment of the auditor, auditor tenure, important issues taken into account by the audit committee in relation to financial statements and handling of these issues, explanation for assuring independence of the auditor in cases where the auditor provides non-audit services, and other information are disclosed in audit committee reports in accordance with the Disclosure and Transparency Rules<sup>38</sup>, the Corporate Governance Code. Moreover, the FRC’s guidance<sup>39</sup> requires description of frequency of the audit committee’s meetings held, contents of discussions and other information as the status of the committee’s activities, in addition to information on accounting audit, in audit committee reports.

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<sup>38</sup> UK Financial Conduct Authority (FCA) “Disclosure and Transparency Rules”

<sup>39</sup> UK FRC “Guidance on Audit Committees” (April 2016)

Many of the above matters disclosed in the US and the UK are currently not required to be disclosed in Japan. With regard to these matters, there were the following opinions:

- Given the relationship in which the auditor receives fees from the audited company, the policy and reasons for appointment and reappointment of an auditor are important information in understanding whether the company appoints an auditor appropriately and whether independence of the auditor is assured and well-functioning. In addition, disclosure of such information could be expected to function as a deterrent to the occurrence of easy opinion shopping in cases where the auditor has a disagreement with the management.
- Assessment of audit should be also disclosed, given the intent of Principle 3-2 and Supplementary Principle 3-2 (1)<sup>40</sup> of Japan's Corporate Governance Code.
- As the audit firm rotation rule has not been introduced, the auditor tenure is important information from the perspective of assessing independence of the auditor.
- The network-based fee amount and outline of services are important information from the perspective of assessing independence of the auditor<sup>41</sup>.
- It should be considered that precise understanding of all contracts for the entire network firms to which the auditor belongs involves a substantive pragmatic burden on companies.
- To understand the audit for the whole group of global companies, entire audit remuneration paid to auditors other than the filing company's auditor and its network firms should be disclosed.
- The status of concrete activities of the Kansayaku Board is information necessary to determine effectiveness of the Kansayaku Board. To understand coordination between the auditor and Kansayaku (Audit & Supervisory Boards member), disclosed information should include not only numerical data such as frequency of meetings held and attendance, but also contents of discussions and how the Kansayaku Board responded to issues pointed out by the auditor. However, since three different institutional designs (Kansayaku Board, Audit and Supervisory Committee and Audit Committee) are allowed under the Companies Act, description should be highly flexible.

Bearing in mind the above matter, in addition to efforts that an entity has made with the auditor to ensure appropriate audits, the policy and reasons for appointment and reappointment of the auditor

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<sup>40</sup> Japan's Corporate Governance Code (excerpt)

Principle 3-2. External Auditors

External auditors and companies should recognize the responsibility that external auditors owe toward shareholders and investors, and take appropriate steps to secure the proper execution of audits.

Supplementary Principle 3-2 (1) The kansayaku board should, at a minimum, ensure the following:

- (i) Establish standards for the appropriate selection of external auditor candidates and proper evaluation of external auditors; and
- (ii) Verify whether external auditors possess necessary independence and expertise to fulfill their responsibilities.

\* It is stipulated that companies listed on Mothers and JASDAQ shall implement the principles of Japan's Corporate Governance Code, or explain the reason if they do not implement the principles.

<sup>41</sup> Other than this opinion, there was a view that information on fee amount of network firms may be also useful from the perspective of determining reliability of accounting audit.



by the Kansayaku Board, as well as assessment of audits, auditor tenure, and network-based fee amount and outline of services divided into audit and non-audit services, which are required to be disclosed in the US and the UK, should also be disclosed in Japan for the purpose of enhancing information on accounting audit.

In doing so, network-based fee amount and outline of services divided into audit and non-audit services should be described in accordance with materiality while taking into account the burden on companies<sup>42</sup>.

In addition, from the standpoint of increasing comprehensiveness in the Annual Securities Reports, the policy for dismissal and non-reappointment of the auditor, reasons for agreement of the Kansayaku Board on the amount of audit fee, and matters concerning a business-suspension order of the auditor, which are disclosed under the Companies Act, should also be disclosed in Annual Securities Reports.

Moreover, together with the above information on accounting audit, it should be required to disclose the activities of the Kansayaku Board (including frequency of the Kansayaku Board meetings held and major considerations, attendance of individual Kansayaku, and activities of full-time Kansayaku<sup>43</sup>), which is deemed necessary to determine effectiveness of the Kansayaku Board's activities in Annual Securities Reports.

## **2. Timing of provision of disclosure documents**

### **(1) Annual disclosure**

In the previous WG report, it was stated that preferably constructive dialogues with shareholders would be enhanced through promotion of efforts such as:

- Disclosing Annual Securities Reports as much in advance as possible before the general shareholders meetings;
- Setting an appropriate date for the annual general meeting and providing the Business Report and Financial Statements early on to secure a sufficient period for considering the general shareholders meeting's agenda items

In addition, to encourage these efforts of companies, the followings should also be considered:

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<sup>42</sup> It is specified that even if the auditor of the filing company is different from that of consolidated subsidiaries, audit fees paid by the consolidated subsidiaries shall also be disclosed, where necessary, in "Other material fees" in the Annual Securities Reports. With regard to audit fees paid to an auditor other than network firms for the auditor of the filing company in relation to consolidated subsidiaries, there was an opinion that it is important to disclose the amount of such fee properly where necessary, from the standpoint of understanding the status of audit of the whole group.

<sup>43</sup> It was pointed out that while matters that are subject to confidentiality may be discussed at meetings of the Kansayaku Board, activities of Kansayaku, including "major considerations" can be disclosed to the extent that confidentiality is not breached, in light of overseas cases and others.

- Addressing description of disclosure documents to allow more flexibility for appropriate setting of a date for a general shareholders meeting by each entity;
- In terms of the procedures, reducing the time required to print/send documents would allow more time for preparing and auditing the Business Report and Financial Statements, and that prompting the electronic provision of the Business Report and Financial Statements would allow companies to provide information to shareholders well in advance to the general shareholders meeting

Taking into account these views, the following efforts have been made for annual disclosure.

#### 1) Electronic disclosure of materials for general shareholders meeting

In February 2018, the Companies Act Subcommittee (regarding corporate governance) of the Legislative Council of the Ministry of Justice published an interim draft proposal for review of the company laws, including introduction of electronic provision of materials for general shareholders meeting. It has been pointed out that the electronic disclosure system is preferable from the standpoint of securing sufficient time for preparing and auditing the Business Report and Financial Statements (hereinafter referred to as the “Business Report”), and securing a sufficient period for shareholders to fully consider the content of materials before the general shareholders meeting<sup>44</sup>. In discussions at the Companies Act Subcommittee, the Financial Services Agency expressed the view from the standpoint of achieving the unification of the Business Report and the Annual Securities Report more easily, that it was preferable to regard disclosure of Annual Securities Reports on EDINET under the Financial Instruments and Exchange Act as a form of electronic disclosure of Business Reports as long as the Annual Securities Reports meet the disclosure requirements for the Business Report and are provided before the general shareholders meeting.

#### 2) Disclosure of Annual Securities Report before the general shareholders meeting

Disclosure of Annual Securities Report before the general shareholders meeting became possible after amendment of the Cabinet Office Ordinance in response to Report of the Sectional Committee on Financial System of the Financial System Council<sup>45</sup> in June 2009<sup>46</sup>.

With regard to the timing of the most recent disclosure of Annual Securities Reports, 22

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<sup>44</sup> It was also pointed out by overseas investors that because investors could not give consideration in Japan as a result of limited time for analysis of materials for the general shareholders meeting due to concentration of meetings, they had no choice but to rely on advisory services and therefore appropriate exercise of voting rights was difficult.

<sup>45</sup> Sectional Committee on Financial System of the Financial System Council “Report by the Study Group on the Internationalization of Japanese Financial and Capital Markets” (June 2009)

<sup>46</sup> The Cabinet Office Ordinance was amended to enable the attachment of Financial Statements to be reported to the general shareholders meeting, as documents accompanying the Annual Securities Report, in place of the Business Report that had been reported to the general shareholders meeting.

companies<sup>47</sup> among companies that settled the accounts during the period from December 2016 to November 2017 (approximately 3,600 companies) provided the Annual Securities Report before the general shareholders meeting. These companies have given the following reasons for the disclosure of Annual Securities Reports before the general shareholders meeting.

- To enhance the disclosure of information to shareholders at general shareholders meetings
- To ensure accountability of the management to shareholders and investors more completely, from the standpoint of timely and proactive information disclosure
- To secure more time for constructive dialogues at the general shareholders meeting by reducing typical questions that can be addressed by reference to the Annual Securities Report

In addition, it is recognized that these companies have improved their reputation from shareholders and investors<sup>48</sup>, and it is preferable that disclosure of Annual Securities Reports before the general shareholders meeting will be getting more popular through spread of such recognition and other means.

Particularly, there was a view that disclosure of Annual Securities Reports before the general shareholders meeting where directors are appointed or dismissed is preferable, partly because it is considered that the incumbent management in the fiscal year is responsible for provided information including assessment and analysis of the entity's status and operating results in the Annual Securities Report.

From the standpoint of promotion of dialogues between investors and companies and more effective exercise of voting rights, each company is expected to make efforts to disclose Annual Securities Report before the general shareholders meeting, taking into account the dialogues with investors and other factors.

### 3) Standardization and unification of the Annual Securities Report and the Business Report

In December 2017, the Financial Services Agency and the Ministry of Justice published "Efforts

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<sup>47</sup> ASKUL, e-Seikatsu, KAGOME, Kyowa Hakko Kirin, Kubota Pharmaceutical Holdings, KOKEN, Komatsu, SAKURA Internet, Sanyo Chemical Industries, The SHIGA BANK, TAIYO BUSSAN KAISHA, TOWA, Japan Exchange Group, HULIC, Hokushin, Hodogaya Chemical, HOYA, Matsui Securities, Yahoo Japan, YAMATO HOLDINGS, Yamane Medical, and LIFENET INSURANCE

<sup>48</sup> Companies that provided the Annual Securities Report before the general shareholders meeting have recognized the following effects.

- High reputation for proactive attitude about disclosure from shareholders and investors
- PR effect as a company in good standing in terms of IR
- Enhanced attitude and awareness in the entity about timely or early disclosure of important information
- Improvement in the accuracy of managerial data management and establishment of an efficient process for preparing Annual Securities Reports, and so on.

to develop an environment supporting unified disclosure” for the purpose of making standardization and unification of descriptions in the Annual Securities Report and the Business Report. Bearing this in mind, the Financial Services Agency amended the Cabinet Office Ordinance in terms of descriptions of large shareholders and stock options in the Annual Securities Report, from the standpoint of standardization with the Business Report in January 2018. In addition, in March 2018, the Ministry of Justice amended the ordinance of the Ministry of Justice with regard to descriptions of large shareholders in the Business Report and the Financial Accounting Standards Foundation published a “template”<sup>49</sup> for cases where descriptions are standardized. As efforts for standardization and unification of the Annual Securities Report and the Business Report are expected to be advanced continuously, it has been stated that the Japanese government shall proactively support companies that strive to implement these efforts.

There was a view that disclosure of the Annual Securities Report before the general shareholders meeting should be promoted through implementation of measures for standardization and unification, while taking into account opinions of relevant parties such as investors and companies. From investors, there was a view that since the content of disclosure was required to be enhanced as a whole, standardization and unification of the Annual Securities Report and the Business Report should be advanced so that these efforts would not substantially lead to deterioration of disclosure on the ground of rationalization<sup>50</sup>.

## **(2) Timing of publication of material information**

The stock exchange rules require that material information that may have an effect on stock prices of listed companies should be published in a timely manner. For timely disclosure, while it is stipulated that the content of information shall be disclosed immediately, timing of publication by many listed companies concentrates on after 15:00, which is the end of market hours of stock exchanges (that is, “after the close of the trading sessions”), or later<sup>51</sup>.

With regard to these practices, it was pointed out that transactions after material information was fully digested by market participants are appropriate from the viewpoint of formation of stock prices and it is preferable to publish such information after the end of market hours.

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<sup>49</sup> “Matters concerning disclosure of the Annual Securities Report - initiatives taking into account <Efforts to develop an environment supporting unified disclosure>-”

<sup>50</sup> For example, it was pointed out that since omission of information on the address of large shareholders, business offices and plants prevents relevant parties from actually visiting the site to make a check, such information should not be removed from items to be disclosed.

<sup>51</sup> With regard to material information, a detailed explanation in the case where media reported a so-called “scoop” shows a similar tendency.

On the other hand, it was noted that since information is immediately reflected in stock prices at any time in this age when there are diverse trading markets, time to digest information cannot be secured in fact, and the situation where investors in Japan have no choice but to accept prices formulated on the initiative of overseas investors, despite information on Japanese companies, is rather a problem. From this perspective, there was a view that disclosing such information before market hours when possible is preferable, so that the information can be utilized for transactions in Japan's capital markets.

About effects on individual investors, there was an opinion that individual investors are considered to hold shares on the assumption that they are behind institutional investors in terms of trading speed, and it is important to disclose information timely and accurately so that they can understand what happened when stock prices fluctuated.

As material information that may have an effect on stock prices of listed companies is required to be disclosed timely, each company should make efforts for swifter publication of material information, in light of needs of investors in Japan who hope to obtain and analyze information in a timely manner and trade in Japan's capital markets while communicating with companies where necessary.

### **(3) Quarterly disclosure**

While changes in the business environment surrounding companies are happening rapidly and business results are also changing drastically in the short term, the quarterly reporting framework has been legislated based on the understanding that information on business results should be disclosed to investors more timely and companies need to verify business management more accurately by grasping information in companies more timely<sup>52</sup>.

In the previous WG report, with regard to summary of financial results including those in each quarter, the Tokyo Stock Exchange reviewed the Listing Regulations and other rules for Quarterly Financial Results in light of preparation and publication workload that should be proportionate to the nature as preliminary report. In keeping with this review, companies have made efforts. For

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<sup>52</sup> In November 1999, disclosure of quarterly information became obliged on the Mothers market of the Tokyo Stock Exchange. Since 2003, the Tokyo Stock Exchange has also required quarterly disclosure on other markets in stages (90% of companies listed on the Tokyo Stock Exchange implemented the disclosure as of the end of 2004). During this period, the Japan Federation of Economic Organizations (Keidanren) requested the consideration of legislation of quarterly disclosure as the "recommendation on quarterly financial report" from the perspective of providing a common ground of accounting and auditing in 2002. In January 2006, it was pointed out that in the Livedoor scandal, legal responsibility could not be charged for false statement of quarterly operating results because any legal quarterly disclosure system had not been introduced. Quarterly reporting was legislated by the enactment of the Financial Instruments and Exchange Act in June 2006 and has been implemented since April 2008.

example, some companies disclose only summary information as Quarterly Financial Reports and have dialogues with investors mainly based on materials for briefing sessions<sup>53</sup>.

As trends in overseas quarterly disclosure rules, in the United Kingdom and France, the quarterly disclosure requirement was abolished in 2014 and 2015, respectively. However, more than half of FTSE100 in the United Kingdom and approximately 80% of companies on Compartments A and B of Euronext Paris in France continue quarterly disclosure voluntarily. In Germany, the legal requirement of quarterly disclosure was abolished in 2015, but the quarterly disclosure requirement has continued under the stock exchange rules<sup>54</sup>. In the United States, the quarterly disclosure requirement has still been continued since the adoption in 1970.

Although various opinions have been heard on the quarterly disclosure rules in Japan, there are the following views that the rules should be reviewed:

- Since emphasis on medium- to long-term corporate value may make quarterly information relatively less important, it should be consider to unify Quarterly Securities Report and Quarterly Financial Results while keeping quarterly disclosure practice, or to make quarterly disclosure voluntary in the future.
- It is preferable to enhance materials for briefing sessions according to the actual situation of companies and promote dialogues based on these materials, while simplifying Quarterly Financial Results. However, there may be room to reconsider Quarterly Securities Report.
- The quarterly disclosure rules may exacerbate the short-term profit-oriented mind of investors and companies, and goes against trends for work style reforms due to a huge amount of labor required for the preparation.

On the other hand, there were the following views that the quarterly disclosure should be kept:

- It is a myopic idea that quarterly disclosure is short-term oriented and that it is to be simplified to promote medium- to long-term investments. Quarterly disclosure is necessary to assess the progress to medium- to long-term goals, and is also essential in anticipating timing when medium- to long-term strategies presented by the companies are realized.
- While problems such as a rise in volatility in stock prices, incentive to wrong investment decisions of some investors and an increase in the burden of management have been pointed out, quarterly disclosure is also particularly important to verify continuous measurement of

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<sup>53</sup> In this case, since preparation of notes to consolidated financial statements require time, summary information and non-mandate materials for briefing sessions were disclosed in advance and then consolidated financial statements were disclosed on the day before disclosure of Quarterly Securities Report. If consolidated financial statements attached to quarterly financial results are disclosed at a later date, companies are allowed the option to post Quarterly Securities Report on TDnet.

<sup>54</sup> These systemic revisions were made in line with amending Directive (November 2013) of EU's "Directive on the harmonization of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market (Directive 2004/109/EC)." In the amending Directive in 2013, the matter pointed out on emphasis on short-term operating results and others were cited as reasons for the amendment (Directive 2013/50/EU).

KPIs and investment thesis (investment goal, hypothesis) of investors.

- Quarterly disclosure is a standard in advanced countries' markets;
- As it is said that the content of disclosure of listed companies in Japan is not as good as that in Europe and the United States, if abolition of the quarterly disclosure is considered to set back companies' attitude toward disclosure, this may discourage overseas investors' investments in Japan.
- Quarterly disclosure is one of the achievements resulting from efforts that we have made for many years to create free and vibrant capital markets open to the world, and behind recent Japanese capital markets attracting so many overseas investors is the sophisticated disclosure including quarterly disclosure.
- Academically speaking, research on markets in Europe and the United States has reported benefits such as a decrease in bid ask spread, that means lowered information asymmetry among investors, or a reduction in capital cost after voluntary or mandatory disclosure. This is interpreted as an increase in quality and reliability of information and more efficient price formation in markets mainly because settlement of accounts four times a year has made it difficult to manipulate earnings.
- To convince investors of quarterly disclosure to be made on a voluntary basis, transparency and reliability from the standpoint of investors and capital markets need to be first increased further, for example by enhancing disclosure by Japanese companies like annual reports in the United Kingdom and changing practices that overseas investors deem opaque such as cross-shareholdings.
- While Quarterly Financial Results are useful, Quarterly Securities Report to which audit review is conducted is extremely important from the viewpoint of improving reliability of figures in financial results.

In addition to the views above, there are indications that information gap may expand between individual investors and institutional investors as well as research findings showing heightened volatility in stock prices, including excessive response of stock prices of companies in the United Kingdom and France that do not make quarterly disclosure to quarterly disclosure information of peer companies in the same sector in the United States.

As just described, with regard to quarterly disclosure:

- many people have views that assessment of progress would be significant for making investments from the medium- to long-term perspective, and in addition,
- disclosure of information that is especially important to improve medium- to long-term corporate value, such as non-financial information, is not necessarily sufficient at present;
- framework and governance for making not only half-yearly and quarterly disclosure but also disclosure of material corporate information as a whole are not necessarily sufficient;

- it has been pointed out that price formation in markets has been conducted more efficiently due to information disclosure;
- in such situations, for example if quarterly disclosure become voluntary, it is considered that this may be deemed as a setback of disclosure and affect competitiveness of Japan’s capital markets.

Given these views, we do not change the quarterly disclosure rules at this moment, and it would be considered a sensible approach to advance efforts to increase flexibility of disclosure of Quarterly Financial Results and monitor the development of disclosure of financial and non-financial information and sufficiency of timely disclosure of corporate information in Japan, as well as overseas trends and examine appropriate ways where necessary.

#### **(4) Quiet period**

So-called “quiet period” is a fixed period before announcement of financial results that is set by a company under its internal rules as a period during which the company voluntarily refrains from IR activities to prevent financial results from leaking. Specific length of the quiet period and responses during the period vary among companies. Generally, the quiet period of Japanese companies is longer than that of US companies<sup>55</sup>. There is a view that this is attributable to longer period between the end of the fiscal year and the date of announcing financial results.

In Japan’s capital markets, in response to non-preferable practices in which analysts obtained information on financial results before the quiet period (so-called preview meetings), in some cases, certain securities firms refrain from contacting companies for around two weeks before the end of each financial period. Some pointed out that this may be a problem from the perspective of promoting dialogues, since those firms cannot have dialogues with companies for one and a half months before announcement of each financial results, or six months a year.

In this regard, while certain companies do not accept any dialogue with investors during the quiet period, many companies make positive use of the period as opportunities for dialogues with investors on medium- to long-term strategies, governance or wide-ranging business environments

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<sup>55</sup> According to a survey of all listed companies in Japan conducted by the Japan Investor Relations Association, of 973 companies that responded, 73% set a quiet period. Of them,

- 1) Companies that set a period from the fiscal closing date to the date of announcing financial results as their quiet period account for 60%, and the average length is 36 days.
- 2) Companies that set a period before a certain period of time prior to the date of announcing financial results as their quiet period account for 37%, and the average length is 27 days.

(the Japan Investor Relations Association “24th status survey on IR activities (2017)”)

In the United State, a survey conducted by the National Investor Relations Institute (NIRI) shows that of 378 surveyed companies, about half of companies that established a quiet period set 17 to 30 days before the date of announcing financial results as their quiet period (NIRI “NIRI Earnings Process Practices Research Report” (2016)).



and risks, plant tours and others.

Furthermore, the Japan Securities Dealers Association's guidelines<sup>56</sup> have clarified for analysts the ideal way of dialogues at the end of each fiscal year. In addition, the legal framework regarding fair provision of information have been improved through introduction of the fair disclosure rules for issuers.

Therefore, as for the quiet period and around the end of the fiscal period, the common understanding among concerned parties should be developed based on practices in other countries so that companies could shorten the quiet period and seek more proactive dialogues during the quiet period, and that analysts could also have dialogues with companies on information other than financial results appropriately.

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<sup>56</sup> Japan Securities Dealers Association "Guidelines concerning Association Member Analysts' Interviews, etc. with Issuers and Communication of Information" (September 2016).

## **IV. Other matters**

### **1. Provision of information utilizing IT, EDINET and others**

EDINET has been an infrastructure for disclosure and use of information among companies and users since the introduction in 2001. As distribution channels for information have been diversified by progress in information and communications technologies, IT utilization has been developed further. To be more convenient, access from tablets and other devices should be supported. In addition, it is possible to consider extending the period of public posting of disclosure documents under the Financial Instruments and Exchange Act in the future in light of needs for the extension and balance with cost.

### **2. Disclosure of information in English**

With a continued increase in overseas investors' holding ratio of shares in Japan's capital markets, calls for companies' data of financial statements and narrative information written in English are being heightened further.

Currently, while approximately 90% of constituents of Nikkei 225 prepare annual reports in English, the English version of the Annual Securities Report is rarely prepared. For example, it is pointed out that information about cross-shareholdings provided only in the Annual Securities Report is not communicated sufficiently with overseas investors.

In addition, there is an opinion, from companies, that even if they disclose the English translation of the Annual Securities Report on their website, they receive few accesses from outside. In this regard, there were the following views:

- overseas investors do not always collect information in English from the website of each company;
- as most overseas investors gather information via information vendors, posting English information on public systems such as EDINET would be practically effective in terms of facilitating information provisions through vendors

Therefore, we should implement the following efforts:

- With regard to information on EDINET, to proceed with translation in English on the system to a certain extent, including creation of headings of main tables in financial statements and submitted documents in English.
- To encourage companies to translate the Annual Securities Report into English, a list of companies that post the English version of their Annual Securities Report on the website could be published on the Financial Services Agency website, and it should be encouraged to make

public on companies' website information on cross-shareholdings in English that is requested strongly by overseas investors.

- When companies have already translated their Annual Securities Report into English voluntarily, to allow posting them on the English version of EDINET website.

## **Conclusion**

The above is results of deliberations in this working group. Looking ahead, we hope that development of appropriate systems will be advanced in light of the points of view presented in this report. In addition, we strongly expect to achieve a positive spiral where implementing continuous efforts, such as follow-up of actual disclosure status and effects of development of systems will lead to disclosure/provision of more enriched corporate information to investors, which ensures appropriate functions of capital markets and ultimately bears fruit in the form of increased corporate value and household income.

End