JICPA Special Committee on
Corporate Disclosure and Governance

Discussion Paper

Key Issues in Enhancing Usefulness and Trust in Corporate Disclosure

– Establishing Sustainable Value Creation Cycle through Interaction between Disclosure and Governance –

May 14, 2021

The Japanese Institute of Certified Public Accountants

Contents

Introduction

In recent years, corporate disclosure of non-financial information, including ESG, has become increasingly important. Accordingly, measures have been taken to enhance the disclosure of narrative information including corporate governance in the Annual Securities Report, which is central to the disclosure system in Japan.

Meanwhile, the global movement to drive forward the unification of sustainability standards is also picking up steam. Various organizations are working on initiatives for the disclosure of non-financial information, including developing frameworks and standards as well as disseminating and promoting such frameworks and standards. Furthermore, the EU countries as well as the UK and the US are making progress with policy responses to strengthen the mandatory disclosure of non-financial information, such as climate-change information and human capital information.

In Japan, some companies are proactively working on disclosure practice to respond to the needs of investors by publishing an Integrated Report as well as the Annual Securities Report. Corporate disclosure is expected to communicate companies' efforts for sustainable value creation led by their management policy.

The Japanese Institute of Certified Public Accountants (hereinafter "JICPA") has conducted various studies[1] on disclosure of non-financial information, and it has established the Special Committee on Corporate Disclosure and Governance in September 2019, with the participation of external experts including investors and independent directors of public companies. The committee identified issues to be addressed to improve the usefulness of and trust in corporate disclosure and discussed the possible solutions to address such issues. The discussion was predicated on corporate information required by investors, and based on the idea that it is important for corporate disclosure to enable entities to sustainably create value through an organic connectivity with corporate governance, while increasing its value to information users by enhancing its usefulness and reliability. Furthermore, the committee also discussed the roles of professional accountants to support and safeguard the disclosure system.

Based on the above studies, JICPA published the Interim Report on August 21, 2020. After the publication of the Interim Report, JICPA conducted interviews with experts such as business professionals, investors and academics and received feedback on topics discussed in the Interim Report. To compile this Final Report, the Special Committee on Corporate Disclosure and Governance discussed various issues pointed out in the interviews and desirable directions to be taken with respect to corporate disclosure and reflected the results in the descriptions of "Current state and issues to be addressed" and "Possible solutions" in each topic of this Report.

Since after the publication of the Interim Report, there have been heated discussions on non-financial reporting, especially internationally. In light of various advances made by such relevant organizations, the necessary updates were made in this Final Report in terms of information considered to have significant impact.

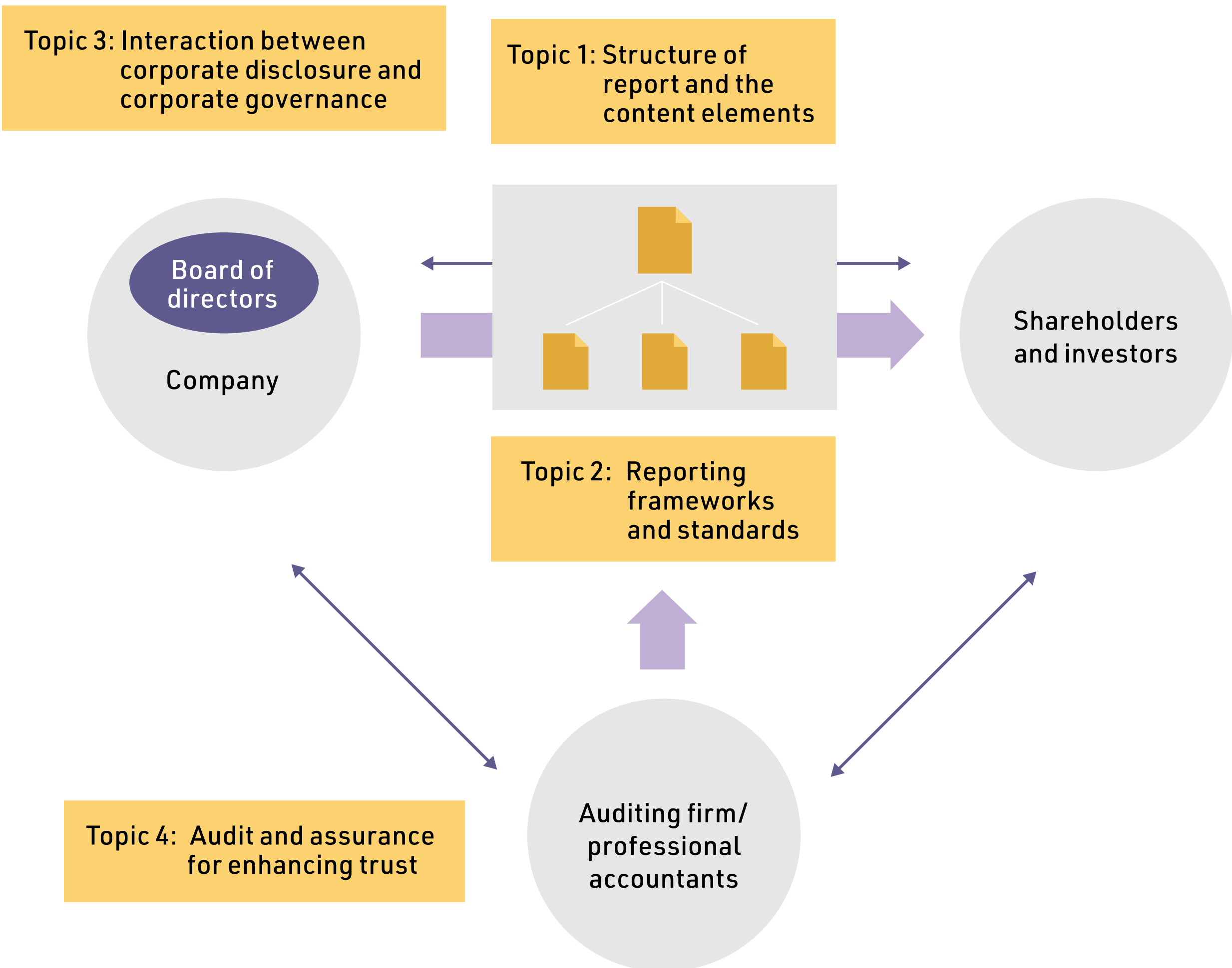
1 JICPA has conducted research and studies under the initiative of the Management Research Committee to contribute to improving disclosure practices of non-financial information in voluntary disclosure documents, including the Integrated Report and the Sustainability Report, for more than 10 years. In recent years, it released the Research Report No. 59 of Management Study and Research Committee titled "How can corporate reporting practice support long-term oriented behaviour of institutional investors? –Consideration with focus on non-financial information–" in May 2017 and summarized points to be focused on by institutional investors when they take actions from a long-term perspective. Based on such a perspective, JICPA conducted a case study on Integrated Reports and released the Management Research Committee Report No. 68 "Case Study on Integrated Reporting" in July 2019. In addition, in February 2018, the Integrated Reporting Project Team issued the "Vision for the future of integrated reporting and the role of professional accountants: Building a corporate reporting model to support sustainable value creation".

Executive Summary

In recent years, there is growing interest in the quality of non-financial information as the importance of non-financial information in corporate reporting has been rapidly increasing.

Based on the recognition that a high-level and cross-sectional review on corporate disclosure is required in order to improve the quality of corporate information disclosure and to use it as the foundation of sustainable value creation cycle it is necessary to consider from , this Report discusses issues related to corporate information disclosure with a focus on four topics illustrated in the figure below and summarizes the views of the Special Committee on Corporate Disclosure and Governance on the direction to resolve such issues.

The current issues and possible solutions identified by the Special Committee on Corporate Disclosure and Governance are outlined below. For details, please read the main text of this Report.



Topic 1

Structure of reports and the content elements

1-1 Structure of reports

Current state and issues to be addressed

- In Japan, there exist a variety of disclosure media including both mandatory and voluntary disclosures, but their interrelationship is unclear.
- Voluntary disclosure does not have a sound foundation enough to ensure its reliability, and that results in ambiguity in the performance of directors' role.

Possible solutions

- One of the possible directions is to develop a framework that systematically discloses material information for investors' decision makings by placing mandatory disclosure at its core.
- We may establish the position of the Annual Securities Report as the annual report which presents an entity's medium- to long-term direction.

1-2 Responding to two types of user needs: communicating overall picture and providing detailed information

Current state and issues to be addressed

- The format of Annual Securities Reports is specified by each item. While this format ensures comparability and homogeneity of disclosure information, this poses challenge in communicating an overall picture of corporate value.

Possible solutions

- The Annual Securities Report could be more flexible in order to promote the disclosure of an entity's value creation story from the management's point of view.
- One of the possible directions is that the disclosure documents are composed of two parts: 1) a part representing an overall picture of corporate value and 2) a part providing detailed information on individual items.

1-3 Enhanced performance disclosure

Current state and issues to be addressed

- In recent years, it has been pointed out that there is a great deal of variation in the state of disclosure regarding information such as KPIs which represent progress on the strategy or performance and operation of corporate governance, while the future-oriented information disclosure such as strategy has been enhanced.

Possible solutions

- Given the needs of investors (information users), information on performance and progress on business plans is considered to be essential for assessment of corporate value. As such, currently, it is increasingly necessary to enhance the disclosure of historical performance, including a list of KPIs, in annual reports.

Topic 2

Reporting frameworks and standards

2-1 Development and convergence of international frameworks and standards

Current state and issues to be addressed

- Internationally, discussions on the harmonization of standards for non-financial reporting have been gathering speed.
- We expect to see further progress in the development of comprehensive corporate reporting system, which leads to establish the standard regarding a set of the fundamental disclosure components, KPIs disclosure and the measurement methodology.

Possible solutions

- It has become an urgent need to deepen domestic discussions and consider the issues including classifying indicators.
- It is preferable to develop measurement standards, especially for KPIs, considering a balance between comparability and relevance to medium- to long-term corporate value.

2-2 Discussion and development of local frameworks and standards for non-financial reporting

Current state and issues to be addressed

- In Japan, various guidance for non-financial information have been developed, and they have contributed to the enhancement of corporate disclosure; however, their relationships have not necessarily been clear.
- Discussions on non-financial reporting frameworks and standards have progressed internationally, which have clarified the basic principles that reflect the characteristics of non-financial information.

Possible solutions

- In light of the rapid progress of international discussions, it is high time to consolidate good practices and expertise accumulated over the years and to consider what systematic frameworks and standards should be.
- In particular, it is desirable to discuss basic principles for non-financial reporting, upon which corporate disclosure frameworks and standards are based.

Topic 3

Interaction between corporate disclosure and corporate governance

3-1 Roles of the board of directors in corporate disclosure

Current state and issues to be addressed

- Recently, there is a heightened awareness of annual reports as documents to present the entity's views on the future direction, risk awareness and business performance.
- Another challenge is how to ensure a framework where the board of directors, which is responsible for direction of value creation and management oversight, takes the initiative in the disclosure process.

Possible solutions

- It is expected that material matters in the annual report are discussed at the board of directors and these discussions are reflected in the annual report.
- Expectations are high that the board of directors' views are reflected, especially, in the materiality decision-making and assessments of material risks and performance.

3-2 Management/supervisory process and disclosure process

Current state and issues to be addressed

- In some cases, narrative information disclosed in the Annual Securities Report has to be prepared in a short period of time after the fiscal year-end. Also, the preparation policy and information composition of the Annual Securities Report are rarely reviewed by the board of directors.

Possible solutions

- In order to facilitate interaction between the disclosure process and the management/ oversight process, it is expected to coordinate with the board of directors about corporate disclosure from the early stage of the disclosure process.
- We may promote the disclosure on corporate disclosure system and process, while requiring the oversight of the board of directors through the Corporate Governance Code.

Topic 4

Audit and assurance for enhancing trust in corporate disclosure

4-1 Enhancing quality of corporate disclosure: audit and assurance

Current state and issues to be addressed

- As more companies are disclosing financial and non-financial information in an integrated manner in corporate disclosure, the role of external auditors is questioned from the perspective of improving the quality of corporate disclosure as a whole.

Possible solutions

- It is important for external auditors to deepen their understanding of an entity's sustainable value-creation and strengthen their perspective on whether disclosure as a whole represents corporate value.

4-2 Strengthening communication and cooperation between external auditors and those charged with governance

Current state and issues to be addressed

- Given the growing importance of the board of directors as a management supervisory function and the roles of external auditors in narrative reporting in the Annual Securities Report, it has become increasingly necessary for external auditors to deepen communication with the board of directors.

Possible solutions

- It is important for external auditors to deepen communication with the board of directors, especially with independent directors, as those charged with governance on topics such as the entity's management strategies and risks.
- Promoting tripartite cooperation involving the board of corporate auditors, etc. (boards of auditors, audit and supervisory committees and audit committees) is key to improving the effectiveness of audits.

4-3 Reliability of non-financial information

Current state and issues to be addressed

- Internationally, assurance of non-financial information disclosed in annual reports has been discussed from the perspective of ensuring the trust in corporate disclosure.
- In Japan, in case non-financial information is assured, only some of the indicators disclosed in Integrated Reports and other voluntary reports are subject to assurance. Also, these documents are different from Annual Securities Report, which is the scope of financial statement audit.

Possible solutions

- In the course of considering assurance of non-financial reporting, we may face issues, such as scope of assurance, feasibility of assurance ensured in preparation standards, bodies providing assurance and interaction with financial statement audit.
- Assuming the comprehensive use of information by investors, it is desirable that assurance for both financial and non-financial information are undertaken in the same annual report.

4-4 Enlightenment and capacity building of professional accountants

Current state and issues to be addressed

- Now we are facing an increasing need to reidentify the expertise required for professional accountants, taking into account the recent changes in the environment and needs surrounding corporate disclosure.

Possible solutions

- Professional accountants will now need to enhance their comprehensive capabilities in a whole range of themes relevant to corporate management, including business strategy, risk management, performance assessment and analysis, corporate governance and sustainability, in addition to expertise in corporate finance in general.
- We need to review the existing education system for professional accountants and develop a new policy on their expertise from a medium- to long-term perspective.

Chapter 1

Background and Purpose of the Report

In recent years, the importance of disclosing non-financial information in corporate reporting has been rapidly increasing. While an increasing number of companies issue Integrated Reports as a voluntary disclosure document, the Financial Services Agency (FSA) has also strengthened its requirements for entities to enhance the disclosure of narrative information in Annual Securities Reports, a mandatory disclosure document under Japan's Financial Instruments and Exchange Act (hereinafter the "FIEA")[2]. We are now also seeing an accelerated movement to improve the quality of both mandatory and voluntary disclosures[3].

Internationally, there is a growing movement to improve the quality and ensure the reliability of corporate disclosure, including non-financial reporting. For instance, the International Accounting Standards Board (IASB) has been holding discussions toward the revision of the Management Commentary Practice Statement[4]. The International Integrated Reporting Council (IIRC) has also revised the International Integrated Reporting Framework, which was published in 2013, in January 2021. Meanwhile, there is a growing demand from corporate information users, such as investors, for established reporting standards for non-financial information, especially for key performance indicators (KPIs). The International Financial Reporting Standards (IFRS) Foundation and other existing non-financial standard-setting boards including IIRC and the Sustainability Standards Accounting Board (SASB) have accelerated their organizational efforts to respond to such demand[5]. Moreover, from the perspective of ensuring the reliability of corporate disclosure, the International Auditing and Assurance Standards Board (IAASB) has published a guidance document for the assurance of "Extended External Reporting (EER)" including integrated reporting and sustainability reporting in April 2021. Furthermore, in the UK, Report of the Independent Review into the Quality and Effectiveness of Audit, the final report of the so-called Brydon Review, which assessed the quality and effectiveness of audits[6], was published. Since then, there have been vigorous discussions on corporate reporting, including non-financial reporting, as well as on how an audit should be performed in terms of assuring the reliability of the entity.

JICPA has conducted various studies, with a focus on how corporate accounting system and an audit should be designed, from the viewpoint of enhancing the public trust in financial information. It has also participated in international discussions and domestic studies on the disclosure of non-financial information and integrated reporting from the early stage and worked on, among other activities, the development of frameworks and case studies. Through such activities, we have a heightened awareness of growing importance of non-financial reporting and a growing interest in the quality of corporate disclosure as well as an increasing demand for ensuring the reliability thereof in a situation where the disclosure and use of such information are accelerating.

Although the primary objective of corporate reporting, which is to meet the needs of information users, remains unchanged, there has been an increasing focus on its ultimate objective to contribute to establishment of corporate governance as well as stewardship behavior by investors through information disclosure and dialogue process based on it, which eventually leads to sustainable value creation by companies. Improving the quality of corporate disclosure and using it as the foundation of sustainable value creation cycles require a high-level, cross-sectional review not only on what to disclose but also on the way corporate disclosure ought to be, such as a system of disclosure media (documents), standards for preparing information and relationship between corporate reporting and corporate governance. Moreover, public attention is also on the roles of professional accountants who are in a position to ensure such disclosure and governance as third parties. As such, the Special Committee on Corporate Disclosure and Governance has decided to identify key issues with respect to quality of and trust in corporate disclosure and summarize the basic considerations on such issues as the "Summary of topics" from the viewpoint of professional accountants and external auditors with reference to views of the committee members, who have participated in the committee as experts from the standpoints of independent corporate directors and investors.

2 In response to the recommendations of the Financial System Council in the Report by "Working Group on Corporate Disclosure" of the Financial System Council - Realizing a Virtuous Cycle in the Capital Market - issued in June 2018, the FSA amended the Cabinet Office Ordinance on the Disclosure of Corporate Affairs, etc. in January 2019.

3 JICPA conducted a case study mainly on the Integrated Reports for the fiscal year of 2018 and released the Management Research Committee Report No. 68 "Case Study on Integrated Reporting". In this study, it was confirmed that there exist many characteristic cases in terms of highly useful disclosure for investor behavior. Meanwhile, the FSA issued and regularly updates the "Reference Casebook of Good Practices on the Disclosure of Narrative Information". The reference casebook also introduces best practices of such disclosure in reports, including Annual Securities Reports and Integrated Reports.

4 IASB launched a project to revise the Management Commentary Practice Statement in November 2017. It plans to issue an exposure draft of the revised version of the Management Commentary Practice Statement in 2021.

5 Developments by the IFRS Foundation, IIRC and other organizations are described in detail in Section 2.2 of this Report.

6 The report, which is officially titled the "Assess, Assure and Inform: Improving Audit Quality and Effectiveness - Report of the Independent Review into the Quality and Effectiveness of Audit", was authored by Sir Donald Brydon, the former Chairman of the London Stock Exchange.

Chapter 2

Our Review Approach

In order to conduct the review to improve the usefulness and reliability of corporate disclosure (hereinafter this "Review"), JICPA has established the Special Committee on Corporate Disclosure and Governance (hereinafter the "Special Committee") in September 2019. The Committee members include executive members responsible for the quality control of audits, corporate governance or integrated reporting in auditing firms, in addition to JICPA's executive board members responsible for corporate disclosure and audits and assurance. Furthermore, individuals with insights into corporate management and governance, who have served in such positions as independent directors in Japan's leading companies, and an investor have participated in the Committee. The Special Committee has held a total of nine meetings, six meetings before and three meetings after the publication of the Interim Report, and summarized this Report after vigorous discussions.

The Special Committee decided to look at four topics in the review after identifying issues to be addressed with respect to corporate disclosure and grouping such issues. First, in identifying issues to be addressed, the Committee took into account the following three aspects in the discussion with reference to the views of the experts from the standpoints of independent corporate directors and investors, aside from the viewpoint of those engaged in financial statement audit and other assurance services, based on the recognition that corporate disclosure should underpin sustainable value creation cycles in the entire capital market.

1 **Corporate governance**

- How should we make corporate disclosure work effectively in tandem with corporate governance?
- What system and process are required to ensure the quality of non-financial information (narrative information)?

2 **Investor stewardship**

- What kind of disclosure (disclosure method, media, timing and content) is required to enable investors and shareholders to fulfill their stewardship responsibilities?

3 **Audit and assurance**

- What is the relationship between financial statement audit and non-financial information (narrative information)?
- What are the roles that external auditors are required to play with respect to non-financial information (narrative information)?

Then, the Special Committee grouped identified issues into four major topics.

The first topic is the system of disclosure documents and information composition thereof. In recent years, an increasing number of companies have adopted a practice in which several annual reports are prepared across the boundary between mandatory and voluntary disclosures in Japan. Meanwhile, we recognize that there is a lack of clarity concerning the interrelationship between different disclosure media. In light of such recognition, the Special Committee brought up this issue as the first topic to be discussed.

The second topic is reporting frameworks and standards. The Special Committee proceeded with the discussion toward building a framework that is coordinated at both domestic and international levels, taking into account developments in the creation of international reporting frameworks.

The third topic is interaction between corporate disclosure and corporate governance. The Special Committee discussed the need for building a corporate disclosure system and process at the initiative of the board of directors in order for corporate disclosure to work effectively as the basis for dialogue between companies and investors.

The last topic brought up by the Special Committee is audit and assurance. The Committee discussed what kind of roles that audit and assurance should fulfill and how CPAs should act as the main players in such engagements, as well as expertise they are required to have, as the disclosure of non-financial information (narrative information) becomes more enhanced.

Figure 1 below shows relationships between respective topics whereas Figure 2 shows the steps taken by the Special Committee to identify the topics.

Figure 1

Composition of topics in this Report

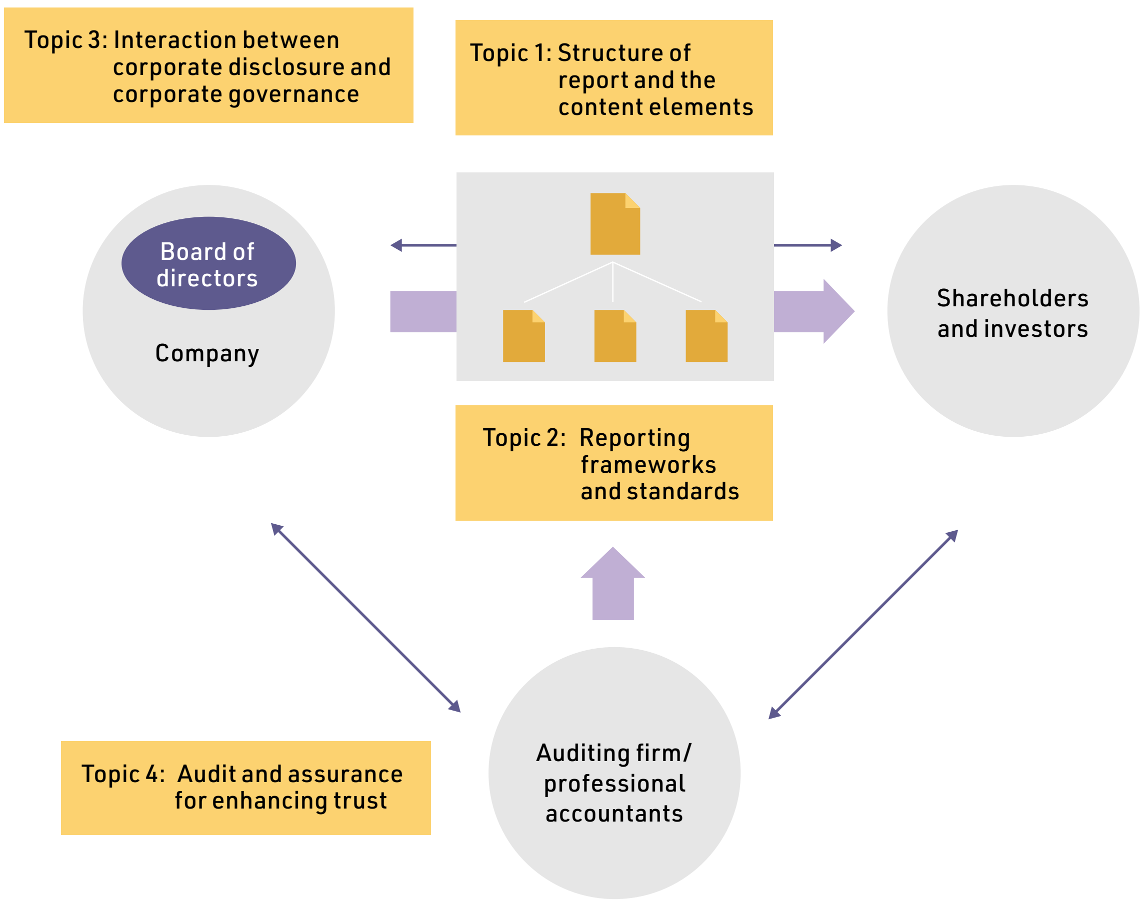


Figure 2

Identification of topics on disclosure in terms of establishing a foundation for sustainable value creation cycles

Three aspects | **Issues to be addressed** | **Topics**

1 Corporate governance

- Meaning of corporate disclosure and ways of cooperation from the viewpoint of establishing governance
- System and process to ensure the quality of non-financial information

Issues to be addressed:

- Responsibilities of the board of directors, audit committee, audit & supervisory committee and board of auditors
- Internal controls over non-financial information

2 Investor stewardship

- Challenges of corporate disclosure from the viewpoint of enabling investors to fulfill their stewardship responsibilities

Issues to be addressed:

- Disclosure in time for the exercise of voting rights
- Response to the needs of both active and passive investors
- Disclosure that enables monitoring of financial and non-financial performance and progress in strategies
- Disclosure of operation of governance

3 Audit and assurance

- Relationship between financial statement audit and non-financial information
- The roles of the external auditors in the disclosure of non-financial information

Issues to be addressed:

- Need for external auditors to have higher point of view (understanding of strategies, business models and the needs of investors)
- External auditors' involvement in non-financial information
- Communication with top management and those charged with governance

Topics

Structure of reports and the content elements

- Structure of reports
- Responding to two types of user needs: communicating overall picture and providing detailed information for analysis
- Enhanced performance disclosure

Reporting frameworks and standards

- Development and convergence of international frameworks and standards
- Discussion and development of local frameworks and standards for non-financial reporting

Interaction between corporate disclosure and corporate governance

- Roles of the board of directors in corporate disclosure
- Management/supervisory process and disclosure process

Audit and assurance for enhancing trust

- Enhancing quality of corporate disclosure: audit and assurance
- Strengthening communication and cooperation between external auditors and those charged with governance
- Reliability of non-financial information
- Enlightenment and capacity building of professional accountants

Based on the above studies, JICPA published the Interim Report on August 21, 2020. After the publication of the Interim Report, JICPA conducted interviews with business professionals, investors and academics and received feedback on topics discussed in the Interim Report. To compile this Final Report, the Special Committee discussed various issues pointed out in the interviews and desirable directions to be taken with respect to corporate disclosure and reflected the results in the descriptions of "Current state and issues to be addressed" and "Possible solutions" in each topic of this Report.

Since after the publication of the Interim Report, there have been intensive discussions on non-financial reporting, especially internationally. In light of various advances made by such relevant organizations, the necessary updates were made in this Final Report in terms of information considered to have significant impact.

Chapter 3

Key Issues of Corporate Disclosure

In this chapter, we will divide the four major topics into several sub-topics and present the results of our review of each of them. Firstly, we will present our understanding of the current state of corporate disclosure and discuss conceivable issues to be addressed. Then, we will summarize the Special Committee's views on the possible solutions to address such issues.

Topic 1

Structure of reports and the content elements

1-1 Structure of reports

With this topic, we will look at the current situation, where many reports are prepared across the boundary between mandatory and voluntary disclosures, and summarize what challenges may arise from such circumstances. At the same time, we will discuss approaches to be taken to address such issues so that information users can use corporate information more efficiently and effectively[7].

Current state and issues to be addressed

1.1 In Japan, there exist a variety of disclosure media including both mandatory and voluntary disclosures. Mandatory disclosure includes the following annual reports: Annual Securities Reports prepared under the FIEA; and Business Reports and Financial Statements prepared under the Companies Act. In addition, there is a report on corporate governance (hereinafter the "Corporate Governance Report"), which exists as a medium for continuous disclosure of corporate governance information under the Exchange Rules[8].

1.2 Recently, an increasing number of companies have adopted a practice to issue voluntary disclosure media, by adding reports to mandatory reports. There are also practices where not only shareholders and investors but also other stakeholders, such as employees, are named as intended users of disclosed information. What is characteristic about such voluntary disclosure practices is that more companies are voluntarily issuing an annual report under the title of Integrated Report or Corporate Report[9]. The advancement in voluntary disclosure practices, represented by Integrated Reports, has led to the current situation where many companies practice an approach to illustrate their own value-creation story in an ingenious way with a focus on their vision, business model and strategies.

1.3 While the Special Committee recognizes the benefits from the advancement in such voluntary disclosure practices, several Committee members expressed their views on the current situation, where diverse disclosure media are prepared by companies, that the relationships between different disclosure media and the overall system of disclosure documents are unclear in many practices (see Figure 3). Some members also pointed out that there is no such report that gives concisely an overall picture of corporate value from the information users' point of view, and, despite efforts made by many companies, the basis of voluntary disclosure, including disclosure rules and responsibilities for information preparation, is not sound enough to ensure its reliability when compared to mandatory disclosure. It was also pointed out from the standpoint of independent corporate directors that it is not clear which of many disclosure media serves as the principal reporting document for shareholders and investors, and that results in ambiguity in the performance of directors' roles in disclosure as required by the Corporate Governance Code. There were also concerns voiced from the standpoint of external auditors over judgments that would need to be made in cases where disclosure in the Annual Securities Report is not consistent with those in other media and where highly-important information stated in a voluntary disclosure document is not disclosed in the Annual Securities Report.

1.4 In the interview with business professionals (preparers) conducted after the publication of the Interim Report, some respondents pointed out that there is no appropriate place in the current mandatory report, i.e., the Annual Securities Report, to address a key massage about what is important for the entity. It is also mentioned that it is necessary to take some measures to allow much flexible reporting from the point of view of companies being conservative in making progressive disclosure in mandatory disclosure, while some acknowledged the positive aspects of the Report, such as that it is ensured in terms of comparability as well as in terms of reliability by being audited. It was also pointed out that strict penalties stipulated in the FIEA with respect to misstatements for all contents of the Annual Securities Report and the absence of safe harbor make it difficult for companies to provide information other than facts, and that leads to strong resistance, especially to providing future-oriented information. There were also opinions about voluntary disclosure from information users' point of view that while some companies exercise their ingenuity to enhance disclosure, some companies disclose information that deviates from their reality, such as a bias toward positive information, and that it may necessary to build a framework that allows much flexible expressions in mandatory disclosure, which entails a legal responsibility for reporting.

Figure 3

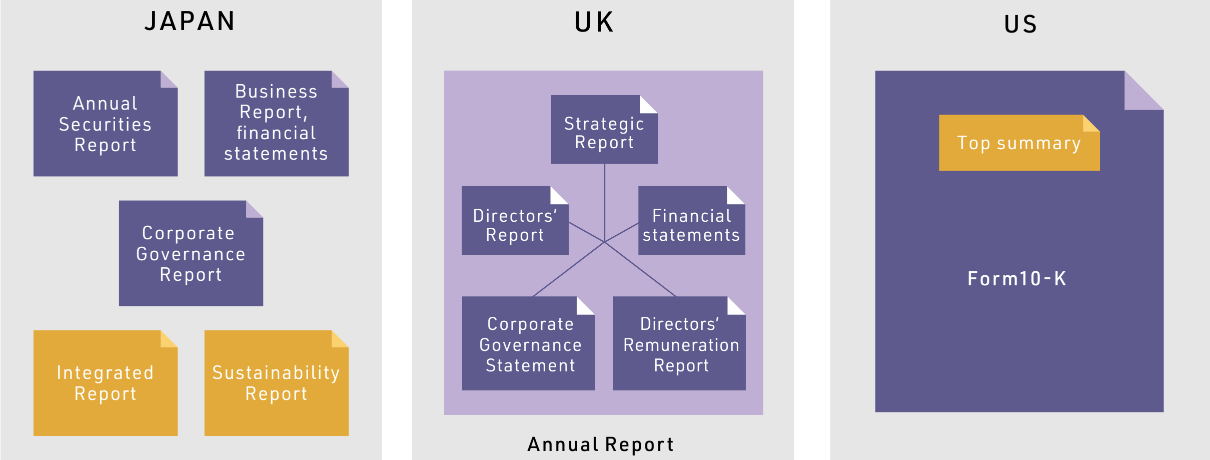
Issues related to the relationship between mandatory and voluntary disclosures in Japan

Issues	Discussion by the Special Committee
There is no such report that gives concisely an overall picture of corporate value.	☐ Investors, i.e., information users, need to read more than one report to grasp the overall picture of corporate value. [Institutional investor, independent director]
The relationships between different disclosure media and the overall system of disclosure documents are unclear.	☐ Disclosing several reports in a way that leaves uncertainty about their mutual consistency may cause duplicate or absence of material information. It is also difficult for readers to detect whether there is any missing information. [Common view among all members] ☐ Different reports are prepared by different departments (mandatory disclosure: the legal department, finance department, etc.; voluntary disclosure: the IR department, corporate planning department, etc.) . That causes inconsistency between different reports, including differences in the content of information contained, differing explanations and differences in tone of explanation (conservative, appealing, etc.). In non-financial (narrative) reporting, it is important to present information in a balanced manner. As such, such differences in tone may cause confusion among users. [Common view among all members] ☐ The preparation of several reports results in the dispersion of resources, duplication of work and extra efforts to ensure the consistency among these reports. That may be the reason why it takes time to prepare disclosures. [Independent director, auditor]
The basis of voluntary disclosure is not sound enough to ensure its reliability when compared to mandatory disclosure.	☐ Voluntary disclosures are neither subject to legal responsibilities for preparing information nor to regulatory supervision. If material information is not disclosed in mandatory disclosure documents but in voluntary disclosure documents only, such information is disclosed without assurance of reliability. [Auditor] ☐ Although companies prepare a variety of reports, only a few of such reports are disclosed before a general meeting of shareholders. And many of them are not discussed by the board of directors. It is not necessarily clear to independent directors which one is the principal report, and to which report they should be committed. [Independent director, institutional investor]

1.5 In the meantime, if we look at corporate disclosure documents in the US and European countries, we can see that mandatory disclosure documents are positioned at the core of corporate reporting, and it is not often the case in practice that a report titled the "Annual Report" is issued independently of mandatory disclosure documents as a voluntary disclosure document. And, even if there is more than one disclosure medium, the relationship is clear between the core medium and other media that provide detailed information. As such, corporate disclosure is more systematized in these countries than in Japan (see Figure 4). In the UK, for example, the Strategic Report has been introduced as a disclosure medium to concisely communicate an entity's material information, such as business model, strategies and KPIs. The Strategic Report is a component of the Annual Report, which covers much broader issues, together with other components, including Directors' Report, Directors' Remuneration Report, Corporate Governance Report and financial statements. In practice, many companies disclose the Strategic Report as a single report, and at the same time, disclose the Annual Report, which covers much broader issues and contains more detailed information. In the US, there is a mandatory annual report submitted to the U.S. Securities and Exchange Commission (SEC) called Form 10-K (hereinafter the "10-K"). When companies issue a report titled the "Annual Report" in practice, they usually add top management's message and summary information, including corporate overview, to the opening section of 10-K. Nevertheless, it is also rare in the US to prepare a voluntary disclosure document independently of 10-K, although some companies publish the Annual Report separately from it[10].

Figure 4

Structure of disclosure media: comparison among Japan, the UK and the US



JAPAN

- Mandatory disclosure documents are filed separately as single reports.
- There is a specified format to be followed by each report. The matters to be stated in an Annual Securities Report are specified by the Cabinet Ordinance.

UK

- Information elements to be included in the Annual Report are specified by the UK's Companies Act and the Guidance on the Strategic Report. Companies can freely decide the composition of the report.
- Although some companies issue the Strategic Report as a single report, most companies disclose the Annual Report, which includes the above reports as its components.

US

- Matters to be stated and their details are specified by the Regulation S-K.
- There is a specified format to be followed.
- Recently, more companies voluntarily include summary information, such as top massage, in the Form.

Mandatory Voluntary

1.6 In France, however, unlike the UK and the US, there has been a practice where the Integrated Report is prepared separately from mandatory disclosure documents. French companies are required to disclose very detailed and specific ESG information in the mandatory disclosure document. To communicate such information in a comprehensible and integrated manner, an increasing number of companies voluntarily prepare the Integrated Report. In response to the trend of such voluntary practice, the Autorité des marchés financiers (AMF), which is France's stock market regulator, recommended in its "Recommendation DOC-2016-13 on social, societal and environmental responsibility" that companies include the Integrated Report in the mandatory disclosure document. At the same time, AMF mentioned that the inclusion of the Integrated Report in mandatory disclosure documents is useful to investors. Furthermore, in order to conform to the "Non-financial Reporting Directive (NFRD or Directive 2014/95/EU)", a disclosure requirement was set out to include non-financial statement (NFS) in a mandatory disclosure document in 2017 and enacted in 2018. As such, the French authority has set out a clear policy of incorporating developments with voluntary disclosure into mandatory disclosure.

1.7 In other countries, there is a growing movement to revise the mandatory disclosure system from the perspective of enhancing non-financial information. In the EU, discussions are undertaken to revise the NFRD. In April 2021, the European Commission proposed a Corporate Sustainability Reporting Directive (CSRD), which will replace the existing NFRD. The CSRD will require companies in Europe to include sustainability reporting in the management report, which is a component of the mandatory annual report, in conformity with established standards. In March 2021, prior to this proposal, the European Financial Reporting Advisory Group (EFRAG), a standard-setting board for financial reporting in Europe, published reports setting out recommendations for the development of EU sustainability reporting standards and for possible changes to the governance and funding of the EFRAG[11]. One of the reports proposes a reporting style where sustainability information is reported in a separate and clearly identifiable section of the management report which would be presented as "sustainability statements" from the perspective of increasing the comparability of disclosure information. As to the sustainability statements, the report proposes that the statements should be easily accessible for users and digitalized, as well as that the segmentation of disclosures should be facilitated by introducing a digital taxonomy.

1.8 In the meantime, in the UK, the Financial Reporting Council (FRC) published a discussion paper "A matter of principles:The Future of Corporate Reporting", which proposes a new structure for corporate reporting, in October 2020[12]. This discussion paper proposes that the UK's mandatory disclosure be structured in a reporting network consisting of three reports: the Business Report, the Financial Statement and the Public Interest Report. Of the three reports, the Business Report is positioned as a developed form of the current Strategic Report whereas the Public Interest Report is proposed to serve as a new medium to provide information, including entities' obligations in respect of the public interest, their performance and future outlooks. As such, the reporting network is proposed as detailed disclosure with enhanced comparability, assuming the active use of XBRL.

1.9 In Japan, the FSA is taking measures to enhance the disclosure of narrative information (non-financial information) in Annual Securities Reports. In June 2018, the Financial System Council issued the "Report by Working Group on Corporate Disclosure - Realizing a Virtuous Cycle in the Capital Market -" and recommended realizing more effective dialogues between investors and companies to enhance corporate value through improved disclosure of narrative information. In response to this report, the FSA issued principles-based guidance titled "Principles Regarding the Disclosure of Narrative Information" as well as a collection of best practices titled "Reference Casebook of Good Practices on the Disclosure of Narrative Information" (hereinafter the "Reference Casebook") in March 2019. After that, to reflect progress with disclosure practices, the Reference Casebook was most recently updated in February and March 2021 in order to realize a virtuous cycle for guidance and best practices. The Reference Casebook contains examples from voluntarily disclosed Integrated Reports. Through such a series of measures taken to enhance the disclosure of narrative information, advancement and achievements made in voluntary disclosure practices will be reflected in Annual Securities Reports. Accordingly, we can expect positive effects on the reestablishment of the position of the Annual Securities Report as the core document of the corporate disclosure for investors.

Possible solutions (recommendations)

1.10 In the discussion by the Special Committee, we shared a basic recognition of the importance of enabling investors, i.e., information users, to efficiently and effectively understand the overall picture of corporate value in a limited period of time, given the objective of the corporate disclosure system. To this end, mandatory disclosure documents should provide investors with both a holistic view of corporate value and the detail information in a manner that enables investors use such information efficiently. At the same time, these documents should disclose all material information for investors' decision makings without duplication or material missing information. It is highly expected that non-financial information in the mandatory disclosure document make progress both quantitatively and qualitatively through several actions taken to enhance the disclosure of narrative information in Annual Securities Reports. One of the possible directions we may take is building a structure of reports that places mandatory disclosure at its core in a form matched to the needs of information users. To achieve this, we need to proceed with initiatives aimed at enhancing narrative information and reflect best practices of voluntary disclosure in practices of mandatory disclosure. From such a perspective, what is important is to clarify the relationship between mandatory annual reports and voluntary disclosure documents and make them more consistent and connected with each other.

1.11 As stated in "Current state and issues to be addressed" in this topic, in other countries, such as the UK or the US, the annual report mandated by the corporate disclosure system is positioned as the core report in corporate reporting. This is different from common practices in Japan where voluntary prepared annual reports coexist alongside mandatory annual reports[13]. The underlying background is considered to be the history of the enhancement of non-financial reporting evolved in annual reports, and the basic concept of placing importance on documents prepared under the leadership and oversight by the board of directors (Topic 3). Internationally, an approach to incorporate the disclosure of non-financial information, including ESG, into the framework of mandatory disclosure documents has been increasingly taken. We can use this approach in other countries as a reference for our discussion on what structured corporate disclosure should be like in Japan.

1.12 In Japan, the number of companies issuing an English version of their Annual Securities Report is increasing. When a Japanese company that does not issue an English version of its Annual Securities Report translates its voluntary report and issues it titled the "Annual Report" or "Integrated Report", it may mislead foreign investors into thinking that such an annual report is a mandatory report. In light of the objective of corporate disclosure, it is important to help information users understand an entity's business conditions and other such information efficiently and effectively by reporting them in an integrated manner. To this end, one of the possible directions we may take is to establish an even more substantiative position for the Annual Securities Report as the principal annual report for investors. This can be achieved by reporting in the Annual Securities Report pieces of material corporate information that are currently disclosed in the Integrated Report or other voluntary disclosure documents, such as medium- to long-term strategies and direction to be taken, risk awareness, financial and non-financial performance and results of management's assessment and analysis of such information. In that case, we may take an approach where other mandatory and voluntary disclosure documents serve as supplements for the Annual Securities Report by, for instance, providing more detailed information.

1.13 From the standpoint of information users, establishing structured corporate disclosure system by placing a mandatory report at its core may enable them to obtain material information concerning corporate value from the principal annual report in a one-stop manner without any duplication or material absence of information, and use such information efficiently by drilling down from an overall picture to more detailed information. The structured disclosure system also enables companies to communicate in a consistent manner throughout the entire disclosed information as well as improve the efficiency of their disclosure practices. Furthermore, from the perspective of reliability of disclosure information, we can expect an improvement by disclosing material information in a report for which normativeness is secured at a certain level through measures, such as principles for the preparation of disclosure information, requirements for the content thereof, responsibilities in case of false statements and monitoring by regulators.

1.14 We reidentified what challenges exist in terms of realizing the systematization of corporate disclosure by placing mandatory disclosure at its core as well as achieving a situation where all material information is effectively disclosed through mandatory disclosure. The following are major challenges to overcome identified by the Special Committee members in their discussions and matters pointed out by many in the interviews conducted after the publication of the Interim Report.

Points to consider to realize structured disclosure placing mandatory disclosure at its core

Matters pointed out on reports

● Style

It was pointed out that current style of the Annual Securities Report, in which matters to be stated are to be written in an itemized and sequential manner, may make it difficult to disclose information, such as top management's message, vision, management strategies, with a focus on story in a flowing style — a style required for the Integrated Report and other voluntary disclosure documents. The current style of the Annual Report places large restrictions on designing. What is called for is a report with sophisticated design like the annual report issued by companies in the UK and Europe, and there is a strong need for much flexible style of the Annual Securities Report (pointed out especially by business professionals).

● Disclosure in English

When disclosing the Annual Securities Report as an annual report in English, the current composition and content of the Report may make it difficult to convey its message to readers. It may be necessary to increase the flexibility of matters to be stated (element-based disclosure) based on the presumption of communications in English (pointed out especially by business professionals).

Matters pointed out on companies' system/process

● System

Some respondents pointed out that there may be a barrier in a company between teams responsible for communication, including the IR department, which actively communicates their corporate value with investors, and teams responsible for mandatory disclosure from the perspective of meeting the institutional requirements, such as the accounting and finance, general affairs and legal departments.

● Process/schedule

It is highly necessary to move up the current preparation process to reflect the content incorporated in the Integrated Report, including its design, in the Annual Securities Report in time for the deadline of submission. It may also be necessary to disclose an annual report in time for the exercise of voting rights, prior to a general meeting of shareholders, in order to ensure the exercise of voting rights by shareholders based on the content of the annual report.

Matters pointed out on information users' evaluation

When compared to voluntary disclosure, the contents of mandatory disclosure information may not necessarily be seen as important or valued. If not only an issue on whether a report is disclosed or not but also those, such as the quality of disclosed information, the content thereof, disclosure media and continuity of disclosure are seen more important or valuable, it may lead to the improvement of companies' disclosure practices.

Matters pointed out on external auditors

● Understanding of non-financial information/sorting out the roles of external auditors

It may be necessary to help external auditors deepen their understanding of non-financial information (narrative information) and facilitate their communication with top management, directors, corporate auditors, etc. In particular, we may need to sort out the way connectivity between financial and non-financial information ought to be and how the reliability of such information should be ensured.

7 We understand that issues related to the integration of disclosures under the FIEA and under the Companies Act is an important topic toward realizing structured disclosure that enables efficient and effective disclosure and use of information. However, the Special Committee focused especially on the relationship between mandatory and voluntary disclosures as various concerned parties, including the Japanese Government and JICPA, have been working on this issue.

8 Japan Exchange Group, Inc. (JPX) explains the background of introducing the Corporate Governance Report on its website as follows: "the decision on what to disclose by the conventional disclosure of corporate governance information through the Summary of Financial Results was left to the discretion of each entity, and such information was disclosed together with other pieces of financial information. Therefore, it was difficult for investors to make their own comparison of or judgment on each entity's corporate governance system"; and to address such problems, "each entity's corporate governance information is summarized in the form of a report and posted as the list of such reports on the website of the Tokyo Stock Exchange at all times."

9 According to the Survey of Integrated Reporting in Japan 2020 published by KPMG Japan, 579 companies issued an Integrated Report in 2020, and the companies account for 81% of the Nikkei 225 constituents and 65% of JPX-Nikkei 400 constituents.

10 International Business Machines Corporation (IBM) is one of the examples of companies that publishes an annual report separately from 10-K in the US. IBM issues a report, whose composition is unique and different from that of 10-K, under the title of "Annual Report". Its 10-K contains not much information as descriptions in the main sections of the report tell which pages to refer to in the Annual Report (FY 2019 Annual Report consists of 143 pages whereas 10-K consists of 29 pages). The company's financial statements and independent auditor's report (Report of Independent Registered Public Accounting Firm) are also disclosed in the Annual Report so that it can fulfill the disclosure requirements under the U.S. Securities and Exchange Act of 1934 with its Annual Report. Southwest Airlines issues a report titled "One Report" which has similar characteristics to the Integrated Reports issued voluntarily by Japanese companies.

11 https://www.efrag.org/News/Project-476/Reports-published-on-development-of-EU-sustainability-reporting-standards

12 https://www.frc.org.uk/accountants/accounting-and-reporting-policy/clear-and-concise-and-wider-corporate-reporting/frc-future-of-corporate-reporting-project

13 The recent movements to enhance corporate disclosure include the requirement for disclosing certain environment and employee information in annual reports under the EU Accounts Modernisation Directive (2003) and the introduction of the Strategic Report in the UK under the amendments to the Companies Act 2006.

1-2 Responding to two types of user needs: communicating overall picture and providing detailed information for analysis

With this topic, we will look at two types of needs of information users — a need to grasp the overall picture of corporate value, including key factors related to sustainable value creation by companies; and a need to analyze individual detailed information — as well as a system of corporate disclosure media capable of responding to such needs efficiently and effectively.

Current state and issues to be addressed

1.15 In this Review, there was an argument that the recent needs of investors, i.e., information users, could be roughly classified into two types: a need to grasp the whole picture of an entity as to its direction to be taken, risks and current situation; and a need to analyze individual detailed information. The former is mainly the need of investors who are engaged in active funds and use disclosed corporate information to assess entities' corporate value based on future cash flow evaluation. Such a need is also expected from people engaged in the exercise of voting rights or engagement activities in passive funds. The information that responds to such a need includes top management's message, strategies, business model, risk overview, key performance highlights and analysis of results thereof. These investors place a high value on being able to quickly and clearly understand an entity's status and learn more about the story of its value creation. On the other hand, the latter is the need of investors, such as analysts and ESG research analysts, who need to analyze corporate data more deeply by actively utilizing data. The information that responds to such a need includes detailed risk information, information on production and orders received, facility information, contract information and individual ESG information. These investors are assumed to place more value on depth of detail, volume and comparability of data. These needs are not necessarily be clearly distinguishable from one another. For instance, there might be a need of active fund managers to grasp the whole picture of corporate value as well as to analyze themes, in which they have more interest, more deeply using detailed data. Accordingly, there is a growing need for a framework which effectively delivers useful information to respond to both of the two major needs to understand the overall picture and analyze corporate information in detail.

1.16 In the interviews conducted after the publication of the Interim Report, more than one business professionals stated their expectations for mandatory reports in terms of easiness to communicate an entity's value-creation story. In particular, some respondents pointed out that it is necessary to take some measures to allow much flexible reporting in the Annual Securities Report from the point of view of companies being defensive to mandatory disclosure, while agreeing on the need for the section giving an overall picture of corporate value. Specific issues on disclosure in the Annual Securities Report identified in the interviews are as follows:

- Although we are working to increase the number of descriptions on our business models and strategies, which represent out value-creation story, in sections such as "Description of Business" and "Subsidiaries and Other Affiliated Entities" in "Overview of the Company" and "Management Policy, Business Environment, Issues to Address" in "Overview of Business" in the Annual Securities Report, what trouble us is that information is scattered across items to be stated.

- We provide material information, including top massage, business models, strategies and highlight information, in the first half of the Annual Report prepared for foreign stakeholders. However, it is difficult to disclose material information at the beginning of the Annual Securities Report and realize reporting written in a flowing style.
- The composition of the Annual Securities Report is different from that commonly adopted for internationally-required annual reports.
- Because the design of the Annual Securities Report is predicated on document filing, it is difficult to giving an attractive report structure with sophisticated design.

1.17 In recent years, other countries, such as the UK and the US, have been facing the issue of rapidly increasing information volume in corporate disclosures due to the trend toward the expansion disclosure of non-financial information. The introduction of the Strategic Report in the UK was the regulatory action to this increase in the volume of disclosure information, and focuses mainly on disclosing highly material information in a story-based manner[14]. The Annual Report in the UK is composed of the Strategic Report, which briefly reports the entity's business model, strategies, both financial and non-financial performance and future outlook, as well as other documents prepared to provide more detailed information. Moreover, recently, there is an accelerated movement in the EU and the UK to develop data platforms, which provide detailed information, in combination with reports, which provide both non-financial and financial information giving an overall picture of corporate value (management report, Strategic Report), while increasing their comparability (see 1.7).

1.18 Annual Securities Reports in Japan are premised on the separate disclosure of each information category. This style has the advantage of ensuring comparability and homogeneity of disclosed information, and also seems to be matched to the need to understand information necessary to assess corporate value in detail. In the discussion by the Special Committee, while the positive aspect of the itemized disclosure was much appreciated, many Committee members shared a common awareness that there is a challenge with respect to responding to the needs of readers who wish to briefly grasp an overall picture of corporate value and who wish to understand a series of value-creation stories in a flowing style starting from vision, business model, strategies, actions to performances. And they said that this is the reason that many companies voluntarily issue an Integrated Report. Although the Integrated Report and other voluntary disclosure documents tend to be used as a medium to communicate the overall pictures and stories of corporate value (Topic 1-1), they have problems in terms of normativeness and the disclosure structure. That is why there were many voices heard in the discussion calling for the development of an environment where entities can communicate the whole picture of their corporate value in a flowing style through mandatory disclosure documents. At the same time, there were views that some measures must be taken to realize concrete and detailed corporate disclosure as the volume of disclosure information in Japan is not as sufficient as it is in the UK and the US.

Possible solutions (recommendations)

1.19 In recent years, corporate disclosure has been required to be capable of responding to both needs: a need to grasp the overall picture of an entity's value creation; and a need to analyze individual detailed information and data. The common disclosure elements to respond to the need to grasp the overall picture of an entity's value creation among the Strategic Reports in the UK, IASB's management commentary and Integrated Reports include information such as vision, business model, strategies, risks and KPIs and the review thereof (Management Discussion & Analysis (MD&A) that encompasses both financial and non-financial information). A practice to briefly and flexibly report such information particularly important to assess corporate value in the foreword of an annual report is considered to be matched to this need. In addition, such information as management's message by the CEO or CFO and the message from the chairperson of the board of directors has become indispensable for an annual report both inside and outside the country as it represents their recognition or intention as to the direction that their company is heading, current business conditions, issues to be addressed and others from the management's point of view.

1.20 For the global practice of preparing annual reports and the practice of voluntary disclosure by domestic leading companies, initiatives are underway to realize story-based reporting written in a flowing style by forming an organic and bidirectional connection between such top management's message and information elements, such as strategies. In the discussion by the Special Committee, many members expressed the view that future-oriented and story-based reporting from the higher-level and managerial points of view is also expected for the Annual Securities Report, which serves as the principal disclosure document for investors in Japan. Also, facilitating the connectivity among information elements, including future vision, business model, strategies, risks, KPIs and MD&A, in Annual Securities Reports is expected to lead to realizing corporate disclosure capable of responding to the needs of information users who wish to grasp the overall picture of the value-creation process in a limited time frame, as well as those who wish to understand material information.

1.21 In the discussion by the Special Committee, members have come to the conclusion that, in order to realize such highly connected disclosure, it should consider developing an environment that enables much flexible information composition. To do this, it is also necessary to address the response to corporate disclosure that ensures comparability of the individual items to be stated in light of the needs of information users who have a strong interest in specific information and those who need detailed analysis. As the movement to develop data platforms for corporate disclosure has been intensified, especially for information of which the comparability is needed to be ensured, there is a rapidly growing need for developing a disclosure foundation with an eye on digital transformation (DX).

1.22 Taking into account these different needs of information users and different natures of information, we may make the structure of mandatory reports for investors be composed of two parts: a part representing an overall picture of corporate value; and a part providing detailed information on individual items to be stated. In that case, it is preferable to provide a framework that enables more flexible disclosure of information that gives an overall picture of corporate value in the foreword of the annual report under the title that clearly indicates that the report gives an overall picture of corporate value; stipulate only basic required disclosure elements, such as management policy, business model, strategies and governance; and allow a reporting company to decide the composition and design of the report with flexibility. Meanwhile, it is expected to put individual required disclosure items in place for the disclosure of the individual items to be stated from the perspective of ensuring their comparability (see Figure 5).

Figure 5

Classification of corporate disclosure information: information giving an overall picture and information on the individual items to be stated

	Information giving an overall picture	Information on the individual items to be stated
Priorities	☐ Emphasis on story ☐ Concise reporting ☐ Not required to disclose in an itemized manner ☐ Flexibility in deciding how to present required disclosure elements (strategies, business modes, governance, etc.) in reports	☐ Emphasis on granularity and comparability of information ☐ Enhancement of the disclosure of detailed governance information and financial and non-financial KPI information (including material sustainability information), with the current matters to be stated in the Annual Securities Report as a starting point
Disclosed information	☐ Top Management message ☐ Vision and policy, business environment, business models, strategies, issues to be addressed (overall recognition) ☐ Major risks ☐ Policy for corporate governance, governance arrangement and review of the operation of corporate governance ☐ Remuneration system and actual remuneration ☐ KPI highlights ☐ Performance review (MD&A of financial and non-financial information)	☐ Matters to be stated in the Annual Securities Report • Issues to be addressed (detailed description of individual issues) • Information by business segment • Other individual items of information stated in the Annual Securities Report, such as Facilities and Research and Development, etc. ☐ Corporate Governance Reporting • Detailed information on the operation of corporate governance, detailed information on the assessment of the board of directors • Detailed information on remuneration • Detailed information on compliance ☐ Performance Reporting • Detailed disclosure of financial and non-financial KPIs ☐ Financial statements and notes

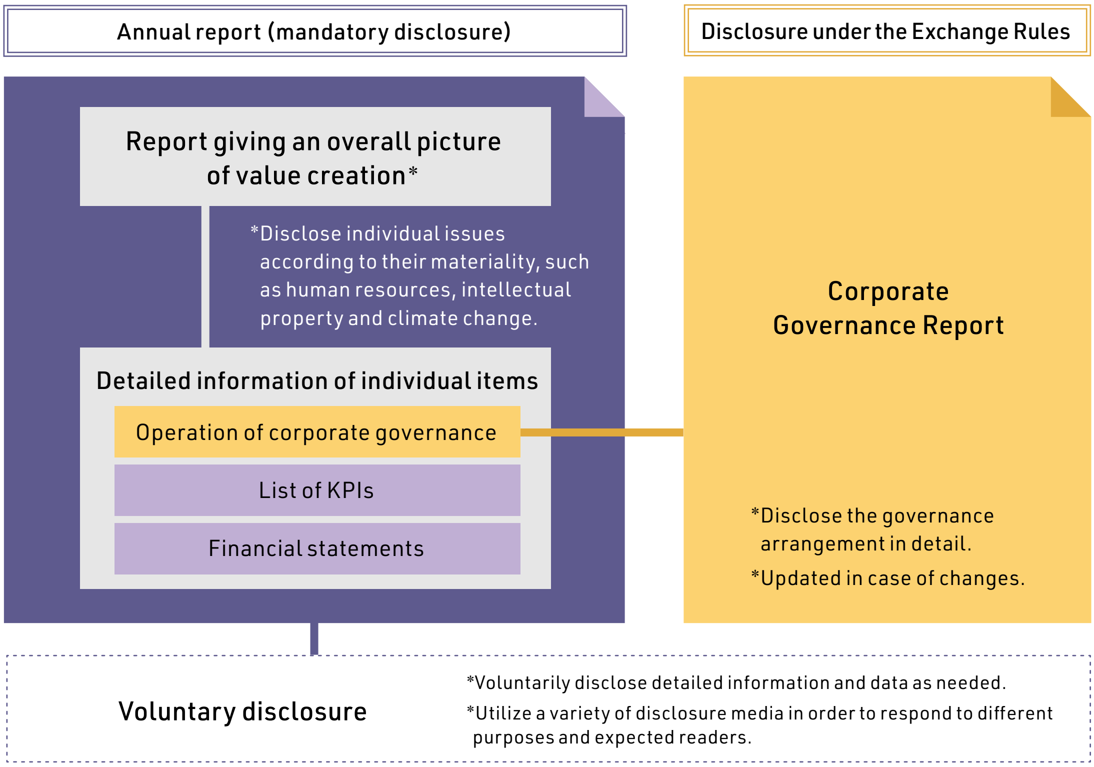
1.23 In the discussion by the Special Committee, how to connect corporate governance information in an Annual Securities Report with the Corporate Governance Report and how to divide the roles between them are pointed out to be another issue to be addressed. In Japan, information on corporate governance arrangement is disclosed in detail in the current Corporate Governance Report. On the other hand, internationally, the content of reporting on corporate governance in annual reports is modernized. As such, it is preferable to enhance the disclosure particularly about the actual operation of corporate governance and remuneration, together with the basic policy for corporate governance arrangement, in Annual Securities Reports, the principal annual report for investors. What were discussed by the Special Committee in regard to the operation of corporate governance are as follows:

- Explanation of how the board of directors and the board of corporate auditors, etc. (supervisory function in an entity, such as boards of auditors, audit and supervisory committees, and audit committees, are collectively referred to as the "board of corporate auditors, etc."; the same applies hereafter) are operated from the perspective of sustainable value creation (recognition and assessment of current situation, issues focused on, approach taken by the board of directors, future issues to be addressed, etc.) in the form of, for instance, a message from the chairperson of the board of directors or the audit committee
- Activities of the board of directors, the board of corporate auditors, etc.
  - Schedule of meetings of the board of directors (including respective committees), the Board of corporate auditors, etc. held
  - Main agendas for meetings of the board of directors, the Board of corporate auditors, etc.
  - Attendance of each director and auditor
- Activities of the nomination committee
- Implementation and the results of effectiveness assessment of the board of directors and individual directors
- Roles of the board of directors in corporate disclosure and process thereof (see Topic 3)

1.24 Figure 6 shows a proposed structure of disclosure documents and information composition thereof that we discussed in Topic 1-1 and 1-2 that places a mandatory annual report for investors[15] at the core of corporate disclosure. The report is expected to become a framework that simultaneously enables entities to communicate an overall picture of their sustainable value creation and report the individual items to be stated in detail, while covering all material information necessary to assess corporate value. In the reporting system, the connectivity and division of roles are also expected to be much clearer between the annual report and the Corporate Governance Report with respect to corporate governance information. In the interviews conducted after the publication of the Interim Report, there was an opinion from an institutional investor that it is desirable to incorporate corporate governance information into an annual report (Annual Securities Report) based on the assumption that the report is to be disclosed before a general meeting of shareholders. Assuming that the annual report will be used as the principal report for investors, it is preferable that voluntary disclosure plays a supplemental role for the annual report rather than being used alone. From the perspective of responding to a variety of information needs, voluntary disclosure documents are expected to fulfill such a role by, for instance, providing information responding to specific needs to support specific users' understanding.

Figure 6

Proposed approach for the systematization of corporate disclosure (Topics 1-1 and 1-2)



Report giving an overall picture of value creation

- Aim to communicate an entity's medium- to long-term value-creation story with information provided in sections named "Management Report Section" and "Corporate Value Report Section".
- Require companies to include top message, business models, strategies, risks, governance overview, key performance review as disclosure elements.
- Allow companies to decide the composition of their reports by increasing the flexibility and not requiring itemized disclosure.
- Realize compact and brief reporting.
- Able to be utilized as an annual report for global investors by publishing the English version.

Detailed information of individual items

- Disclose individual detailed information necessary for investors to assess corporate value in a section named "Individual Reports Section".
- Disclose information centered on the current matters to be stated in an Annual Securities Report, with an emphasis on comparability.
- Reflect the disclosure of databases such as lists of financial and non-financial KPIs.
- Promote digital disclosure by actively employing XBRL technology, etc.

(Note) The above figure does not include information on the timely disclosure of the Summary of Financial Results and other documents as it focuses on annual reports for investors.

14 Financial Reporting Council [2011] "Cutting Clutter: Combating Clutter in Annual Reports"

15 The Annual Securities Report is mainly considered as the mandatory annual report as this Report discusses information disclosure for investors.

1-3 Enhanced performance disclosure

With this topic, we will look at the need for enhancing the disclosure of historical performance and its issues to be addressed, given the international movement toward the enhancement and standardization of the disclosure of information representing the performance of business activities, such as financial and non-financial KPIs.

Current state and issues to be addressed

1.25 International corporate disclosure frameworks and standards place importance on historical performance information, such as non-financial KPIs. For instance, the IIRC's International Integrated Reporting Framework and IASB Management Commentary Practice Statement specify "performance" as one of the main disclosure elements. In a discussion paper titled "Investor Agenda For Corporate ESG Reporting, A Discussion Paper By Global Investor Organisations On Corporate ESG Reporting" jointly issued by the United Nations Principles for Responsible Investment (PRI) and the International Corporate Governance Network (ICGN) in October 2018, it is argued that "companies should seek to identify and publish material ESG issues and relevant KPIs as part of their annual reports".

1.26 Given the needs of investors (information users), information on whether a certain business plan has been put into action and whether any progress has been made is considered to be essential for assessment of corporate value. According to a questionnaire survey of investors conducted by PwC[16], when looking at an entity's long-term strategy, investors place high importance on information on progress made against key priorities and actions for meeting its objectives as well as on overall explanation of its strategy and actions.

1.27 In recent years, it has been pointed out that the state of disclosure varies widely among entities with respect to information that represents historical performance and results of response to challenges, including KPIs on progress with strategy or key issues and operation of corporate governance, while efforts in the realm of voluntary disclosure, such as Integrated Reports, have increasingly enhanced the disclosure of information that represents future direction to be taken by them, including strategies and business models[17]. In the discussion by the Special Committee, some members pointed out that Japan still lags behind other countries in corporate disclosure in terms of volume and depth of disclosed information, especially in reporting on performance and operation of corporate governance. A research on integrated reporting practices in ten countries in 2019 shows an extremely low score given to Japanese companies for the disclosure of performance information[18].

1.28 In Japan, it has also been pointed out how important it is to disclose KPIs. The Principles Regarding the Disclosure of Narrative Information published in March 2019 outline the concept of KPI disclosure and efforts that should be made to realize the preferred disclosure as the Cabinet Office Ordinance on the Disclosure of Corporate Affairs, etc. requires companies to disclose objective indicators to evaluate the status of the progress of their management goals if they use any. Furthermore, the ESG Disclosure Study Group, which was launched in June 2020 on the initiative of companies in the Private Sector, has begun a study on ESG-related indicators.

Possible solutions (recommendations)

1.29 Currently, it is increasingly necessary to enhance the disclosure of historical performance in annual reports. We assume that there may be a growing need for disclosure, especially of the following:

1 Disclosing a list of KPIs (including measurement policy and notes) and providing top management's analysis and views on such performance

- The objective of disclosing KPIs is to enable information users to understand and assess the entity's performance, status of key issues to be addressed and progress in strategies announced in the past. Promoting the practice of disclosing the performance of KPIs may meet the needs of information users who wish to understand progress and the current status of strategies. Adopting the practice, where KPIs are used to explain the performance as part of information on management policy and strategies as well as on Management Discussion & Analysis (MD&A), is considered to be the first step toward this end. Some foreign and domestic companies have already begun to list financial and non-financial KPIs over time and disclose the measurement policy and detailed data as notes in an advance practice. In order to ensure clear, comparable and consistent (continuous) disclosure, listing the performance results for the past several years and disclosing them by clearly stating where to disclose may be one of the possible options.
- Another point to consider is what indicators to disclose. In terms of realizing disclosure relevant indicators to medium- to long-term corporate value, it is preferable to disclose KPIs reflecting the entity's judgment on materiality of its business challenges and risks, not sticking too much to uniform and across-the-board disclosure, while ensuring a certain level of commonality among entities. An entity should select indicators relevant to the industry it belongs to, business model, business environment, business and financial strategies to explain the results of management's analysis on business conditions and progress in strategies, as well as their views on the background, impacts and outlook thereof. That may help investors, who use such information, deepen their understanding of the entity's performance.
- Enhancing the reporting of performance in annual reports enables information users to understand not only the direction of corporate management but also the entity's business conditions and progress in strategies by analyzing and assessing such information from both financial and non-financial aspects. The enhancement may also be effective in terms of corporate governance to improve the effectiveness of the oversight of management through the facilitation of multilateral and continuous monitoring of performance and the progress in strategies by top management and the board of directors.

2 Enhancing the disclosure of operation of corporate governance

- As discussed in Topic 1-2, detailed information on corporate governance arrangement is disclosed in the current Corporate Governance Reports. However, from the perspective of improving the disclosure of operation of corporate governance, it is desirable to connect corporate governance information in the Annual Securities Report with the Corporate Governance Report and divide the roles between them. To this end, one of the possible options is to enhance the disclosure of operation of corporate governance in a mandatory annual report, i.e., the Annual Securities Report, together with the entity's basic policy for corporate governance arrangement.

16 PwC [2014] "Corporate performance: What do investors want to know?"

17 In the "Survey of Integrated Repotting in Japan 2019" (KPMG Japan), it is pointed out that, compared to companies providing financial quantitative targets (86%), a far smaller number of companies report non-financial quantitative targets (26%), and only a limited number of companies use both financial and non-financial indicators to explain the extent of achievement of their strategic targets. The report also points out in terms of corporate governance that whereas an increasing number of companies report a method and frequency of effectiveness evaluations of the board of directors, only a few report the response to issues identified.

18 Oxford University [2019] "Comparative Analysis of Integrated Reporting in Ten Countries"
The assessment criteria used in this research to evaluate the disclosure of performance information include the following: does the discussion of performance in the integrated report disclose quantitative indicators used to measure success with respect to meeting targets; and does the discussion of performance in the integrated report describe the organization's material positive and negative effects? The average score of companies in the 10 countries is 1.79 (a perfect score is 3.0) and Japan has the lowest score of 1.10. In the evaluation of the overall report quality, Japan ranked eighth out of the 10 countries, with a score of 1.38 (1.82 in average).

Topic 2

Reporting frameworks and standards

2-1 Development and convergence of international frameworks and standards

With this topic, we will look at international frameworks and standards for non-financial information and discuss the issues of establishing a coherent corporate reporting system in light of the shift toward mutual cooperation among standard setters and developing established standards.

Current state and issues to be addressed

2.1 There are various international initiatives for corporate reporting and non-financial information disclosure, providing frameworks for basic principles, content elements and presentation methods of corporate reporting, standards for measurement of indicators and supplemental guidelines (see Figure 7). Japanese companies prepare integrated reports with reference to such international frameworks and standards. However, it has been frequently pointed out that the current circumstances where, while there are many standards and other tools for non-financial information, mutual consistency is not sufficiently secured among them in terms of, for instance, the main subject of reporting, may cause confusion among the preparers of annual reports as well as the investors who use them.

Figure 7

List of major non-financial reporting frameworks and standards

Issuing body		Name of framework, standard, etc.	Reporting subject
IASB	International Accounting Standards Board	Management Commentary Practice Statement	Disclosure of Management Commentary
IIRC	International Integrated Reporting Council	International Integrated Reporting Framework	Integrated Report (An entity's value-creation capacity over the short, medium and long terms)
SASB	Sustainability Accounting Standards Board	SASB Standards(The 77 industry-specific standards)	Industry-specific KPIs to be included in SEC filings
CDSB	Climate Disclosure Standards Board	CDSB Framework for reporting environmental and climate change information	Environmental and climate change information
TCFD	Task Forceon Climate-related Financial Disclosures	TCFD Final Report (TCFD Recommendations)	Disclosure of climate-related financial information
GRI	Global Reporting Initiative	GRI Standards GRI Sustainability Reporting Guidelines	Sustainability Report

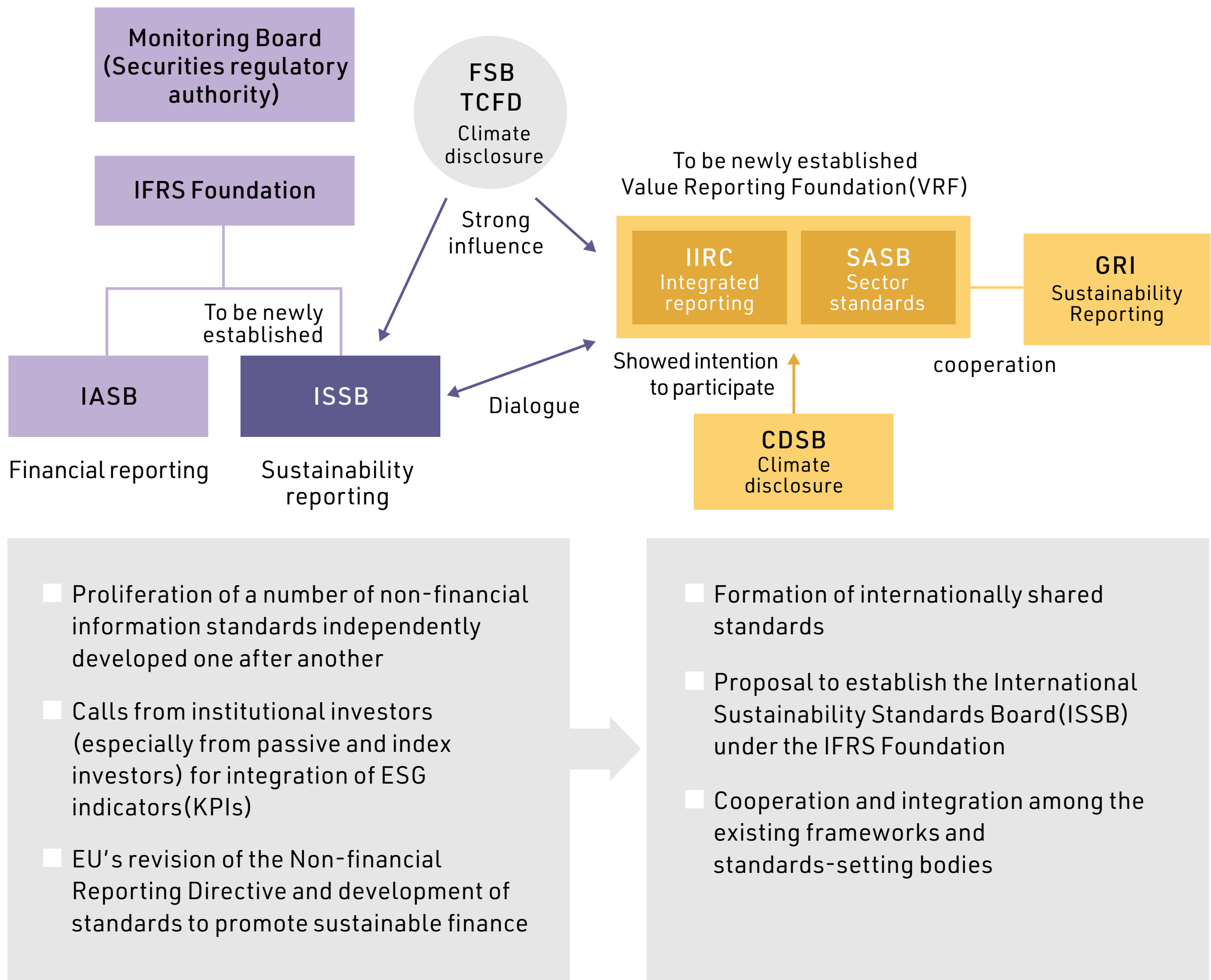
2.2 In response to this situation, in recent years, discussions toward cooperation among standard setters and the alignment aimed for establishing coherent reporting system have been gathering speed. The Corporate Reporting Dialogue (CRD), in which key bodies including IIRC, SASB, GRI and CDSB participate, has launched the Better Alignment Project in 2018 with an aim to promote cooperation and coordination among the standard-setting boards for non-financial reporting, and, in September 2019, published the "Driving Alignment in Climate-related Reporting", which presents the consistency between TCFD recommendations and respective frameworks and standards. Also, Eumedion, a Dutch cooperative organization with membership of asset owners such as pension funds, issued its Green Paper titled "Towards a global standard setter for non-financial reporting" in October 2019, proposing to establish a standard-setting board under the IFRS Foundation. In December 2019, Accountancy Europe, a federation of professional organization of accountants in Europe, issued a report titled "Interconnected Standard Setting for Corporate Reporting", proposing an approach to reorganize the IFRS Foundation and put IASB and the International Non-financial Reporting Standards Board (INSB) together under the Corporate Reporting Foundation, a new foundation to be formed by involving stakeholders relevant to non-financial reporting. Furthermore, in 2020 the World Economic Forum issued a report and proposed to set out common ESG reporting standards in collaboration with the Big Four accounting firms.

2.3 The IFRS Foundation published the "Consultation Paper on Sustainability Reporting" in September 2020. The paper presents an option to establish the International Sustainability Standards Board (hereinafter the "ISSB") [19] as a body responsible for developing coherent sustainability reporting standards based on the recognition of a growing demand. The paper also proposes the IFRS Foundation's policy to focus on the needs of investors and give a priority to the development of standards relevant to climate change in coordination with the existing non-financial reporting initiatives. In the meantime, in November 2020, IIRC and SASB announced their intention to merge and establish a new initiative the Value Reporting Foundation (VRF). The Climate Disclosure Standards Board (CDSB) is also expected to participate in the VRF. As such, the movement to unify various non-financial reporting standards is rapidly gathering pace.

2.4 In parallel with such a global movement to develop coherent standards, in response to the revision of the Non-financial Reporting Directive (NFRD) and the proposal for a Corporate Sustainability Reporting Directive (CSRD), it has been proposed in EU to develop standards for performance indicators. According to a proposal published by the European Financial Reporting Advisory Group (EFRAG) in March 2021, information to be disclosed under these standards will be structured into three layers: sector-agnostic; sector-specific; and entity-specific information. The sector-agnostic indicators are matters to be followed by all reporting entity covered by the NFRD across sectors whereas the sector-specific indicators are matters to be followed by reporting entities in the same industry. Meanwhile, the entity-specific indicators are matters considered to be important for individual entities as a result of materiality assessment. Although these standards cover entities operating within the EU, they are expected to have an impact also on the development of sustainability reporting standards under the initiative of the IFRS Foundation.

Figure 8

Developments of formation of global non-financial reporting standards



Possible solutions (recommendations)

2.5 As corporate disclosure is becoming more globalized, global institutional investors are also considered as one of the primary users of information disclosed by Japanese companies. Currently, non-financial reporting standards have been independently developed one after another by different standard-setters. As such, there is a growing momentum to develop internationally established reporting standards that can resolve such problems. When the international standards for non-financial reporting are developed, Japanese companies may directly adopt such standards to prepare their reports. In Japan, it is also increasingly necessary to proceed with the discussion on and development of frameworks to deal with non-financial reporting (Topic 2-2). As such, it has become an urgent task to deepen discussions domestically and facilitate initiatives, including sorting out the concept of what specific indicators should be disclosed, in anticipation of the development of a corporate reporting standard system that encompasses financial reporting with a focus on communicating medium- to long-term corporate value in the near future. It is also important to accelerate discussions in Japan toward developing new corporate reporting standards that encompass non-financial reporting, while actively participating in international discussions, in order to improve the mutual consistency with Japanese standards.

2.6 Currently, many of the basic components of corporate reporting (e.g., vision, strategies, business model, risks, KPIs, and corporate governance) are commonly adopted between different international frameworks as well as standards for corporate reporting. Although such elements have different names in different countries' systems, it has become a common recognition at a certain level to include them in corporate disclosure. As mentioned in 2.2, their focus has moved to the next step — specific ways of disclosure of KPIs and development of coherent measurement standards. In conjunction with the enhancement of the disclosure of historical performance as discussed in Topic 1-3, in-depth discussion should be carried out on what KPIs should be disclosed as well as how they should be measured.

2.7 Careful and thorough discussions that involve all stakeholders have to be held on what indicators should be disclosed and how they should be measured. In selecting KPIs to be disclosed, while it is essential to select indicators highly relevant to medium- to long-term corporate value, it is also increasingly necessary to ensure comparability of disclosure information among entities because of the increasing importance of indices employed in passive funds management and the need of data vendors, which provide information to investors and analysts. Accordingly, it is preferable to proceed with the development of measurement standards, striking a balance between relevance to medium- to long-term corporate value and comparability, which are the required natures of indicators to be disclosed. One of the directions we may take is to make such indicators be composed of indicators common to all companies; industry-specific indicators; and entity-specific indicators as follows:

- Indicators common to all companies: financial metrics and non-financial indicators expected to be disclosed commonly by all companies such as diversity metrics and greenhouse gas emissions
- Industry-specific indicators: sector-based indicators reflecting characteristics of each industry that should be commonly disclosed by entities in that industry
- Entity-specific indicators: entity-specific indicators reflecting the entity's business model, strategies, etc.

19 Although in the Consultation Paper on Sustainability Reporting published by the IFRS Foundation in September 2020, the standard-setting body was referred to as the Sustainability Standards Board (SSB), at the time of the release of this Report, it is referred to as the International Sustainability Standards Board (ISSB). Therefore, we refer to it as ISSB throughout this Report.

2-2 Discussion and development of local frameworks and standards for non-financial reporting

With this topic, we will discuss the need for further discussions toward the development of local frameworks and standards for non-financial reporting in Japan, amid an accelerated movement to develop international standards. In particular, we will look at various guidance documents for corporate disclosure of non-financial information that have been developed in Japan, and discuss the need for repositioning and systematizing such guidance documents while improving their mutual consistency. Then, we will discuss the need for basic principles that help major parties involved in corporate reporting, including information preparers, users and external auditors, deepen their shared recognition on the way preferable disclosure ought to be.

Current state and issues to be addressed

2.8 There exist multiple guidance documents for non-financial reporting in Japan. The Principles Regarding the Disclosure of Narrative Information were published by FSA as principle-based guidance for enhancing the disclosure of narrative information in a mandatory disclosure document for investors, the Annual Securities Report. Meanwhile, the Ministry of Economy, Trade and Industry (METI) issued guidance for corporate disclosure including voluntary disclosure under the title "Guidance for Integrated Corporate Disclosure and Company-Investor Dialogues for Collaborative Value Creation: ESG integration and non-financial information disclosure and intangible assets into investment" in May 2017 (hereinafter the "Guidance for Collaborative Value Creation"). Furthermore, as the guidance for the disclosure of climate change-related information, the TCFD Consortium issued the "Guidance on Climate-related Financial Disclosures 2.0" in July 2020 (hereinafter the "TCFD Guidance 2.0"). As such, there have already been several guidance documents for corporate disclosure developed in Japan; however, their relationships have not necessarily been clarified[20].

2.9 The Principles Regarding the Disclosure of Narrative Information are the guidance for the disclosure of narrative information in Annual Securities Reports whereas the Guidance for Collaborative Value Creation is the guidance for information disclosure and dialogue process in general regardless of whether it is mandatory or voluntary disclosure. These two guidance documents have a certain level of commonality as they both see strategies and KPIs as key elements of disclosure. However, while the Guidance for Collaborative Value Creation also positions business model, sustainability and ESG as the other key elements, the Principles Regarding the Disclosure of Narrative Information do not directly mention them. Instead, the principles have some descriptions that can be interpreted as treating business model and strategies as a concept included in business policies and strategies in an integrated manner. Also, while these two guidance documents cover the entire corporate disclosure information, the TCFD Guidance 2.0 only covers information relevant to climate change. Moreover, the TCFD Guidance 2.0 does not mention differences in how such information should be disclosed between mandatory and voluntary disclosures. Therefore, each company, i.e., a preparer of disclosure information, has to decide what information and how to disclose it in mandatory disclosure documents.

2.10 Another challenge of Japanese non-financial reporting guidance documents is that they do not present preparers and users of disclosed information with the basic principles to consider when disclosing corporate information in a comprehensive and explicit manner. The FIEA defines in Article 24, paragraph 1 that an Annual Securities Report is a report to state matters "necessary and appropriate in the public interest or for the protection of investors". Meanwhile, the "Points to Note Regarding Disclosure of Corporate Affairs (Guideline for the Disclosure of Corporate Affairs)" specifies in 1-7 the general viewpoints from which the content of a disclosure document should be reviewed (truth and accuracy, materiality, expeditiousness, clarity, objectivity and lawfulness). The Special Committee members shared in their discussion a view on such challenge that these viewpoints should be widely known as the principles for disclosure practices. Considering major recent trends in corporate disclosure, including focus on future orientation, enhancing disclosure of non-financial information and the increased volume of information using accounting estimates in financial reporting, some members also suggested the need for deepening the shared recognition of the principles that reflect the currently needed disclosure model.

2.11 The Principles Regarding the Disclosure of Narrative Information constitute principles for corporate disclosure, such as appropriate reflection of discussions held by the board of directors or management committee, disclosure of material information, disclosure by segment and disclosure of understandable information. However, the principles do not mention principles that are commonly set by IIRC, IASB and other major international bodies such as relevance, fairness/balance, completeness/comprehensiveness and consistency/comparability (see Figure 9). The Guidance for Collaborative Value Creation does not present any principles for disclosure, either. We believe that a shared awareness should be fostered by deepening discussions among parties involved in corporate disclosure on what principles should be focused on as basic requirements to achieve quality and reliable corporate disclosure.

Figure 9

Principles for corporate disclosure by international initiatives, etc.

	IIRC International Integrated Reporting Framework Guiding Principle	IASB Management Commentary Practice Statement Qualitative Characteristics	FRC Guidance on the Strategic Report Communication Principle
Materiality	○	○	○
Views of the board of directors/management	○	○	○
Future-orientation	○	○	○
Relevance	(Strategic focus)	○	○
Fairness/balance	○	○	○
Connectivity	○	(Connectivity with financial information)	○
Reliability / faithful representation	○	○	*1
Completeness / comprehensiveness	○	○	○
Conciseness /clarity / understandability	○	○	○
Consistency / comparability	○	○	*2
Other	Relationships with stakeholders	Verifiability / timeliness	Entity-specific information

*1 The Guidance on the Strategic Report mentions matters to be attended to in its explanation of fairness, including omission of material information, in order not to mislead shareholders, but does not include principles explicitly mentioning information reliability.

*2 The FRC explained the reason for not including consistency in the Communication Principles in the Guidance on the Strategic Report, stating, although consistency from year to year was a quality that investors desired, the FRC concluded that an over-emphasis on consistency might inhibit the more general communication improvements that are seen as priority. The guidance states that it is preferable to disclose KPIs on an ongoing basis, and also mentions the comparability of KPIs.

Possible solutions (recommendations)

2.12 As stated in Topic 2-1, initiatives to develop internal standards in areas of non-financial reporting and sustainability reporting are gaining momentum. Discussions, especially on the following issues are expected to undertake by the EU and the IFRS Foundation going forward. It is also desirable to move forward with the movement in Japan to develop local frameworks and standards for non-financial reporting, while expediting discussions on these issues.

Figure 10

Key issues towards development of frameworks and standards

Objectives	Objectives of reporting, expected users
Fundamental principles	Materiality, connectivity, etc. (Figure 9)
Information elements to be disclosed	Business models, strategies, risks, governance, performance, etc.
Structure of KPIs	Composed of indicators common to all companies, industry-specific indicators, entity-specific indicators, etc.
Organizational boundary to be reported	Consolidated organizations and value chain disclosure
Disclosure and Presentation	・Disclosure of reporting governance and process ・Disclosure of reporting policy ・Disclosure of a list of KPIs, non-financial (sustainability) statement (Topic 1-3)
Other	・Boundary and connectivity with financial reporting ・Individual items to be disclosed with respect to priority themes (climate change, etc.) ・Approach to ensure the feasibility of assurance

2.13 Of these issues, what we should prioritize the most are considered to be the reidentification of the purpose and expected users of non-financial reporting and the establishment of the basic principles, which serve as the skeleton of disclosure practices. International frameworks for disclosure of non-financial information, including IIRC's International Integrated Reporting Framework and IASB's Management Commentary Practice Statement, have set basic requirements to be met from the perspective of achieving the objective of information disclosure, although they have different names in the different frameworks as Guiding Principles and Qualitative Characteristics. The contents of such requirements have a lot in common despite using different terminologies.

2.14 The international bodies have also updated their Guiding Principles and Qualitative Characteristics, taking into account corporate reporting from the medium- to long-term perspective as well as the characteristics of non-financial information. While considering adopting principles, such as fairness, balance, completeness and future orientation, they recognize the need for redefining the concept of materiality as one that encompasses non-financial information. In the discussion by the Special Committee, there were opinions expressed from the point of view that principles are desired to be shared among key guidance documents or guidelines, such as corporate accounting principles and financial reporting frameworks, which are expected to be referred to by preparers and users of disclosed information and external auditors. We believe that in order to ensure the quality of corporate disclosure, the recognition on basic requirements to be met should be shared by parties engaged in corporate disclosure, regardless of whether the disclosure is mandatory or voluntary.

2.15 In parallel with these discussions, it is expected to restructure guidance documents for corporate disclosure by ensuring their mutual consistency while repositioning such guidance documents. In the interviews conducted after the publication of the Interim Report, many respondents, especially business professionals, expressed their recognition that they believe it is necessary for Japanese guidance documents for non-financial information to be systematized and to ensure their mutual consistency, in conjunction with promoting the global movement to develop coherent standards. For example, because these guidance documents use different terminologies for types of information to be disclosed as stated above, it is highly desirable to, at least, use consistent terminology among them. In the meantime, when developing the guidance on a specific subject, such as the disclosure of climate-change information, it is preferable to use shared disclosure elements and principles by positioning such guidance under the existing comprehensive guidance, as well as to clearly state in the comprehensive guidance the mutual relationship with and the position of the guidance on specific subject.

20 Nissay Asset Management Co., Ltd. [2019] GPIF Commissioned Research "Study of ESG Information Disclosure"

Topic 3

Interaction between corporate disclosure and corporate governance

3-1 Roles of the board of directors in corporate disclosure

With this topic, we will discuss the roles expected to be played by the board of directors in corporate disclosure, taking into account the recent debate centering around the roles of the board of directors in corporate governance and the heightened awareness of annual reports as documents to present the entity's views on the future direction, risk awareness and performance. Although under the current Japanese Companies Act, companies are allowed to adopt one of three corporate structures — a company with a board of corporate auditors, a company with three committees, or a company with an audit and supervisory committee, the Review in this Report is not limited to a particular corporate structure.

Current state and issues to be addressed

3.1 Since the introduction of the Corporate Governance Code, the governance of Japanese companies has changed dramatically. The Special Committee shared awareness of the following issues in its discussion:

1 Roles of the board of directors

While there is an increasing focus on corporate direction setting, development of a risk-taking environment and oversight of management as the roles of the board of directors, awareness of the importance of the separation of management and oversight functions is also increasing[21].

2 **Independent directors**

As more companies have introduced independent directors, the number of independent directors has been on the rise. The power of independent directors in the oversight of management has been strengthened such that more companies have appointed an independent director as the chairperson of the board of directors[22].

3 **Nominal to effective**

The corporate governance, especially corporate direction setting and the effectiveness of oversight by the board of directors is what is now being questioned.

3.2 Today, there is a heightened awareness of annual reports as documents to present the entity's views on the future direction, risk awareness and performance both internationally and domestically[23]. From the standpoint of shareholders and investors, some argue that disclosed information cannot be taken into account in shareholder behavior or dialogue between shareholders/investors and companies unless it reflects the views of those charged with governance[24], especially the board of directors, which is responsible for fulfilling corporate direction setting and oversight. In the interviews conducted after the publication of the Interim Report, some business professionals pointed out that investors, especially foreign investors, place importance on whether disclosed information is confirmed by the board of directors. The importance of obtaining confirmation from the board of directors was also pointed out for information used as the presupposition of dialogue between companies and investors in order to facilitate such dialogues. Furthermore, some respondents noted the need for establishing governance by companies and developing internal controls for the preparation of information in terms of ensuring the reliability of non-financial information.

3.3 Furthermore, the board of directors is increasingly being seen as a key in ensuring quality of corporate reporting, particularly in European countries. IIRC's International Integrated Reporting Framework states that those charged with governance have the ultimate responsibility for an integrated report, and in many cases, the board of directors assumes such responsibility. ICGN also calls for a new corporate reporting process led by the board of directors, as discussed in "Possible solutions (recommendations)" in this Topic.

3.4 Corporate disclosure plays a critical role in the establishment of corporate governance. Constructive dialogue between shareholders/investors and companies can only be fully facilitated when companies reflect the discussions by and views of the board of directors in their corporate disclosures and receive feedback thereon from shareholders and investors. As such, the interaction between corporate disclosure and corporate governance will help build the foundation of a sustainable corporate value-creation cycle.

3.5 The Corporate Governance Code and the Principles Regarding the Disclosure of Narrative Information mention the roles of the board of directors. However, a practice where the board of directors plays a key role in the preparation of an Annual Securities Report has not yet been fully adopted by Japanese companies. About 60% of the listed companies reportedly specify the Annual Securities Report as a matter to be discussed by the board of directors ("The Results of the 20th

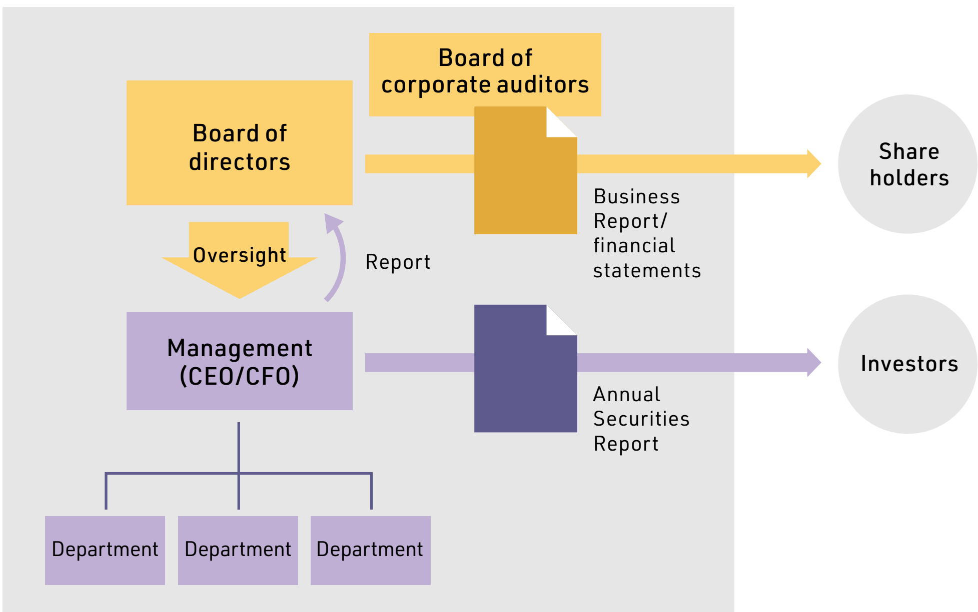
Internet Questionnaire Survey (Changes in Officer Composition, etc.)", Japan Audit & Supervisory Board Members Association). In the discussion by the Special Committee, members pointed out the following as, in particular, the issues behind such situation:

- Although the board of directors' views should be reflected in corporate disclosure documents, especially in mandatory disclosure documents, such awareness is not fully shared by top management and directors.
- The basic roles of the board of directors in corporate disclosure (especially the roles of the board of directors in relation to the roles of top management and those of the board of corporate auditors, etc.) are not clearly defined[25].
- Companies have not established internal systems and processes to ensure that the board of directors fulfills its roles.

3.6 The institutional requirements for the involvement of the board of directors in corporate disclosure are different between the Companies Act and the FIEA (see Figure 11). Under the Companies Act, the Business Report and financial statements are required to be approved by the board of directors. On the other hand, the FIEA stipulates that top management (Representative Director and Chief Financial Officer (CFO)) shall be responsible for the preparation of the Annual Securities Report. Under the Financial Instruments and Exchange Act, investors, including potential shareholders, are defined as the intended users of disclosed information. The challenges lie in how to develop the internal systems and processes required for corporate disclosure. Moreover, as stated in the Principles Regarding the Disclosure of Narrative Information, another challenge is how to ensure a framework where the board of directors takes the initiative in the disclosure process because of the increased importance of reflecting the views of the board of directors in the Annual Securities Report, in addition to those of top management.

Figure 11

Board of directors and corporate disclosure



Possible solutions (recommendations)

3.7 It is important for the board of directors to oversee the organizational system and process of corporate disclosure to safeguard the quality of corporate disclosure. Japan's Corporate Governance Code has been developed based on the G20/OECD Principles of Corporate Governance. The principles state that the ultimate responsibility to ensure the integrity of the reporting system shall be assumed by the board of directors and positions the oversight of the processes of both disclosure and communications as the board of directors' responsibility.

3.8 Furthermore, out of consideration for the views, especially of investors, there is also an increasing awareness of the importance of reflecting views of the board of directors in the recognition of the entity's direction of corporate value creation, performance and risk awareness to be included in corporate disclosure. Japan's Principles Regarding the Disclosure of Narrative Information require that not only management's views but also the board of directors' discussions should be appropriately reflected in the narrative information in Annual Securities Reports. Meanwhile, ICGN's Global Governance Principles specify what should be emphasized in the oversight of corporate disclosure by the board of directors in order to ensure the reflection of such views in disclosed information (the numbers within the brackets represent the numbering of the respective principles) as follows:

- Whether the disclosed information provides balanced views of the company's position and prospects (7.1)
- Whether all material information that affects corporate value is disclosed (7.2)
- Whether the disclosed information present a true and fair view of the company (7.3)
- Whether the disclosed information help shareholders understand the company's strategic objectives and progress toward sustainable value creation (7.5)

3.9 In order for the board of directors to fulfill its supervisory function with regard to corporate disclosure, it is important to discuss material matters in annual reporting at a board meeting every fiscal year and reflect what was discussed in the annual report. The Special Committee members shared an awareness that, for instance, it is highly necessary to reflect the board of directors' discussions, especially in the materiality decision-making and assessment of material risks. As such, there is a growing need for clarifying the ideal form of systems and processes as well as how the board of directors should oversee the entity's corporate disclosure to ensure that an annual report reflects substantial rather than superficial views of the board of directors.

3.10 In addition to the board of directors' disclosure system and processes, coordination with a body responsible for the audit function, such as the board of corporate auditors, etc., is also important for the board of directors. In the audit committee and the audit and supervisory committee, non-executive directors, who are constituents of the board of directors, are either the audit committee members or the audit and supervisory committee members. Therefore, these committees are designed in a way that the board of directors' supervisory function and audit function work together in an integrated manner so that the board of directors can fulfill its role as the body charged with governance. In a company with a board of corporate auditors, on the other hand, the board of directors is designed as a separate board from the board of corporate auditors; therefore, it is expected to develop the new system and process to effectively reflect the views of the board of directors in annual reports through dialogue and cooperation between non-executive directors and corporate auditors.

3.11 In the interviews conducted after the publication of the Interim Report, some pointed out that it is not practically feasible for members of the board of directors to read through all information disclosed in the Annual Securities Report and other such documents. It was also pointed out that if the board of directors assumes responsibility for disclosed information, it is necessary to discuss what aspects should be included in the scope of the responsibility. Options suggested in the interviews include an approach where the board of directors approves only material information to be disclosed by adopting a disclosure regime similar to that for the Strategic Report in the UK; and an approach where the board of directors oversees the development of materiality policy as well as disclosure systems and processes.

21 The proposal for the revisions of Japan's Corporate Governance Code has been published on April 6, 2021. In this proposal, the demonstration of the board of directors' functions is set out as a key theme because the board of directors are required to support and effectively oversee management's prompt and decisive risk-taking as well as making important decisions.

22 The proposal for the revisions of Japan's Corporate Governance Code published in 2021 emphasizes the importance for companies listed on the Prime Market to appoint enough independent directors to account for at least one-third of the board of directors, and if considered necessary in light of their business environment and business characteristics, etc., appoint enough independent directors to form the majority of the board.

23 For more details, refer to statements that explain the purport of each of the guidelines, including IIRC's International Integrated Reporting Framework, the Strategic Report in the UK and FSA's Principles Regarding the Disclosure of Narrative Information.

24 Auditing Standards Committee Statement (ASCS) No. 260 "Communication with Those Charged with Governance" defines those charged with governance as "the person(s) or organization(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity", and at the same time, states that "in Japan, the board of directors, corporate auditors or the board of corporate auditors, the audit and supervisory committee or the audit committee fall into those charged with governance in accordance with the provisions for the establishment of organs in the Companies Act".

25 Some members of the Special Committee expressed the view that it would probably be necessary to foster a certain level of shared awareness of the roles to be played by the chairperson of the board of directors and his/her accountability, in addition to that of the roles of the board of directors.

3-2 Management/supervisory process and disclosure process

With this topic, we will look at what challenges may arise from seeking interaction between the management/supervisory process and disclosure process with regard to the supervisory function of the board of directors on corporate disclosure discussed in Topic 3-1. Moreover, we will also discuss the meaning of such connection from the viewpoint of corporate governance.

Current state and issues to be addressed

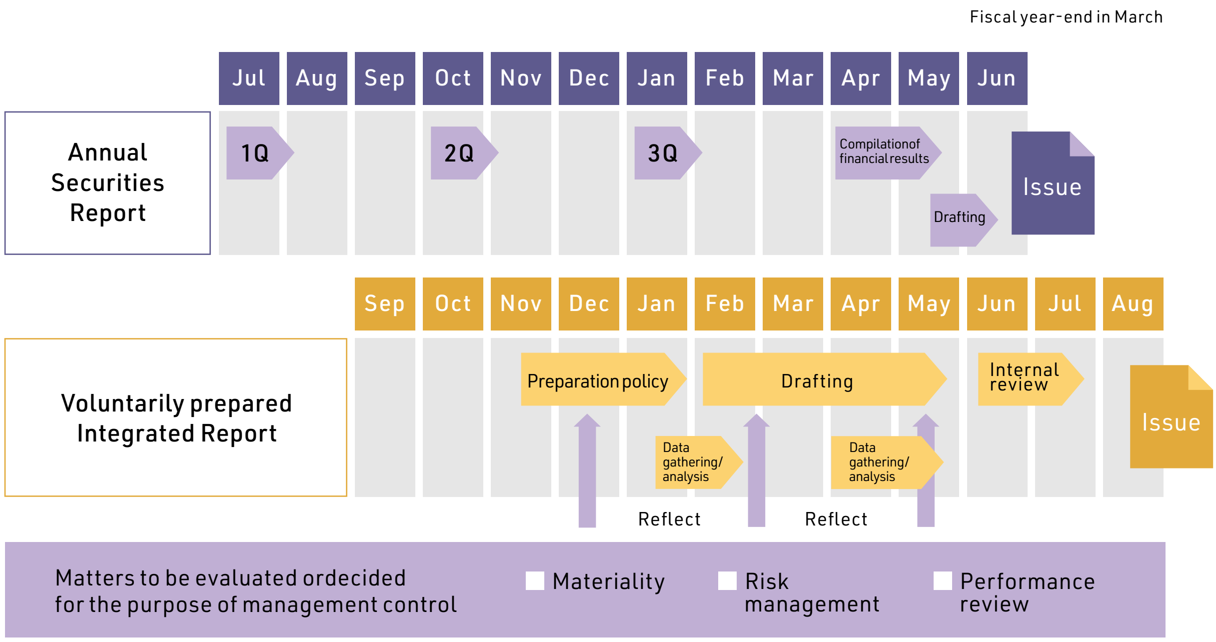
3.12 As stated in Topic 3-1, it is highly required for the board of directors to fulfill its role of overseeing corporate disclosure. To this end, it is expected to ensure linkage between the processes of overseeing management and reporting

3.13 The narrative information in an Annual Securities Report, which is a mandatory disclosure document, is prepared after the fiscal year-end, and in some cases, during the period between preparation and submission of the financial statements. In addition, some say it is rare that the preparation policy or composition elements of the Annual Securities Report are reviewed by the management committee or other deliberative bodies attended by directors.

3.14 In the meantime, there are some practical examples of voluntary preparation of an Integrated Report, where the board of directors gets involved in the preparation and approves the report. Moreover, in some cases, the report even contains a statement from the board involved in its preparation. Furthermore, an increasing number of companies have adopted a practice of reflecting the results of business risk assessment or those of materiality assessment on major business issues performed as part of the management/supervisory process.

Figure 12

Example annual timetable for corporate disclosure (in a company whose fiscal year ends on March 31)



Possible solutions (recommendations)

3.15 Connecting the disclosure process with the management/supervisory process is vital to reflect the views of top management and the board of directors in corporate disclosure. To this end, an annual report should be prepared over a period from a point in time much earlier than the fiscal year-end to the submission/release date, and through a process from determination of disclosure policy, determination of information composition, data gathering/reflection of assessment results, reviews to final approval. And, gaining the consent of the board of directors for the disclosure policy from such an early stage of the process and undergoing monitoring of procedures, such as data gathering, by the board of corporate auditors, etc. will make the approval of the board of directors more effective.

3.16 Assessments such as risk assessment and materiality assessment on key business matters are usually performed as part of the management/supervisory process. However, it is also important to reflect the results of such assessments and judgments in corporate disclosure. Connecting the management/supervisory process with the disclosure process in this way enables a provisional compilation of various types of non-financial information, including management policy, issues to be addressed and risk information, at a relatively early stage before the fiscal year-end. By doing so, MD&A information can also be discussed prior to the fiscal year-end based on performance forecasts. Of course, such information should be updated before the release to reflect changes in circumstances by the time of compiling the final version of the Annual Securities Report. However, in the meantime, holding discussions between the board of directors, the board of corporate auditors, etc. as well as external auditors before the fiscal year-end based on provisional information enables an early compilation of non-financial information, and moreover, facilitates more effective interaction between the management/oversight process and the disclosure process (see Figure 13).

3.17 Additionally, companies are expected to improve the transparency with respect to the aforementioned materiality policy and assessment results, as well as the disclosure process involving the board of directors and other bodies. International frameworks, including IIRC and GRI, require explanations of the entity's policy, structure and process of corporate reporting, especially from the perspective of materiality decision-making. In fact, a greater number of companies are currently disclosing information on materiality and the disclosure process in their voluntary disclosure documents. Encouraging disclosure of such information in Annual Securities Reports is one of the possible directions we make take. In the interviews conducted after the publication of the Interim Report, there was a view expressed by both sides, companies and investors, that it is important to promote the specific disclosure of corporate disclosure systems and processes, including the application of materiality. Some respondents pointed out that requiring the disclosure of disclosure systems and processes including the involvement of the board of directors is more effective to facilitate the best practices reflecting the board of directors' views than mandating the approval of the board of directors for information to be disclosed. Taking these ideas as the basis, we may promote the disclosure on corporate disclosure system and process, while requiring the oversight of the board of directors through the Corporate Governance Code using the comply-or-explain method.

3.18 Enhancing the connection between the management/supervisory process and the disclosure process, centering on the board of directors, may lead to the reflection of the board of directors' views in corporate disclosure as well as to improving the reliability of disclosed information through a more sophisticated control environment for corporate disclosure. Collecting material information and building a systematic process for communicating top management's view may make it possible for the board of directors to perform a series of processes, from formulation of strategies to monitoring of performance, more effectively.

Figure 13

Example process of involvement of the board of directors and the audit committee in corporate disclosure (in a company whose fiscal year ends on March 31)

January	February	March	April	May
Planning meeting of contributors (*1)	Contributors draft templates for their roles and areas of responsibility.	The disclosure committee approves the overall structure and technical compliance of the report.	Draft report presented to the audit committee for initial comment on key messages, themes and overall balance.	The audit committee assesses the report on behalf of the board of directors as to whether it is comprehensive, fair and balanced.
Agree responsibilities, process and governance, as well as the overall structure for the report.	Draft the structure of the report.		Report sections updated based on year-end results.	The remuneration committee reviews the remuneration report.
Decide the structure and process to assess whether the report is fair, balanced and understandable.	Clarify linkages between component elements in the draft.		Review the consistency with other disclosure media.	The Chairpersons of the audit, remuneration and nomination committees compose introductions to their reports.
	Auditors review the structure of the report and provide comments.			Final report presented to the board of directors, audit committee and remuneration committee for approval.

Prepared by changing the fiscal year-end of the timetable to March 31 from what suggested in Appendix 1 of Deloitte' s Annual Report Insights 2019.

(*1) **The suggested agenda for annual report planning meeting are as follows:**

- Consider how to ensure that all elements of the entity's annual report meet the regulatory requirements and effectively convey strategically important information to shareholders.
- Agree the key messages and themes that will flow through the report and get the board of directors and the audit committee buy in.
- Discuss and agree how materiality will be applied to the annual report as a whole.
- Agree how to avoid the "silo effect".

Topic 4

Audit and assurance for enhancing trust in corporate disclosure

4-1 Enhancing quality of corporate disclosure: audit and assurance

With this topic, we will look at the roles of audit and assurance engagements in corporate disclosure amid a growing need for integrated disclosure of financial and non-financial information, from the perspective of contributing to improving the quality of corporate disclosure.

Current state and issues to be addressed

4.1 In an audit of financial statements, it is necessary to identify the risks of material misstatement and assess such risks. To achieve this, external auditors are required to understand the entity's external environment, business activities as well as its objectives and strategies[26]. In addition, since the so-called "Accounting Big Bang", companies are required to make accounting estimates in more situations due to the wider use of fair value-based measurement. Accordingly, understanding the entity's strategies and business risks is vital to evaluate the reasonability of accounting estimates in audits. Furthermore, in recent years, we are witnessing a move by investors, who are users of financial reporting, to better understand the investee entity's non-financial information, including business model, strategies, business risks and non-financial performance, so as to reflect such information, together with financial information, in the assessment of and dialogue with the entity. The role of external auditors is questioned from the perspective of improving the quality of corporate disclosure as a whole, including the disclosure of not only financial but also non-financial information, amid a growing comprehensive understanding of financial and non-financial information among information users.

4.2 There are also more measures being taken with a focus on ensuring the reliability of non-financial information. To date, external auditors have been required to read through "other information" in an audit of financial statements. Due to the revision of the Auditing Standards in November 2020 and the revision of the Auditing Standards Committee Statement (ASCS) No. 720 "The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements" in January 2021, in addition to considering such information in terms of consistency with financial statements and whether there is any material inconsistency with knowledge acquired in the course of the audit, they are also required to pay close attention to any indication of a material misstatement of fact in the information even if it is not relevant to financial statements or knowledge obtained through the audit[27]. Meanwhile, the final report of the Brydon Review, titled "Independent Review into the Quality and Effectiveness of Audit" recommended expanding the role of external auditors in non-financial reporting in the UK. IAASB also advanced a project to develop a guidance document on the assurance of "Extended External Reporting (EER)", including integrated reporting and sustainability reporting[28] and published the "Non-Authoritative Guidance on Applying ISAE 3000 (Revised) to Extended External Reporting (EER) Assurance Engagements" in April 2021. As seen in such movements, there are expectations for sorting out approaches for the assurance of non-financial information and improving the efficiency of such engagements.

Possible solutions

4.3 In the discussion by the Special Committee, members shared recognition concerning challenges as to whether audit practices are sufficiently coping with the corporate governance reforms, which are currently underway in Japan. We believe that many companies' control environments have been impacted by substantial changes in the governance structure, such as, in particular, clarified roles and supervisory responsibilities of the board of directors, increased number of independent officers, introduction of companies with the audit and supervisory committee structure and increasing adoption of such a structure by companies. Understanding the arrangement and operation of the entity's corporate governance, especially in terms of the control environment, is also key to assessing internal controls, on which the audit of financial statements is premised. Therefore, we need to consider and discuss more deeply how to utilize information, including disclosed corporate governance information, the results of effectiveness assessment by companies and communication with directors and corporate auditors in audit engagements.

4.4 As mentioned above, more in-depth understanding of the entity's business environment, business model, strategies and internal controls, as well as risk assessment based on such understanding are important in an audit of financial statements. During their discussion, the Special Committee placed particular emphasis on the need for external auditors to deepen their understanding of entity-specific sustainable value-creation models through communication with top management and directors and strengthen their perspective on whether disclosure as a whole appropriately represents corporate value. Meanwhile, in the risk assessment in a financial statement audit, external auditors are also increasingly required to more deeply understand business risks that may impact on medium- to long-term corporate value as well as short-term business risks that directly impact on the audit risk of material misstatement, and to assess the impact of such risks as the situation demands. Furthermore, they are now required to read through and consider "other information" in disclosure documents that contain financial statements to be audited so as to address material inconsistency and misstatement in such information. To this end, they have to perform a further examination on specific process and matters to be considered.

4.5 In Topic 1 of this Report, we looked at the need for structured disclosure that encompasses both financial and non-financial information, which enables the understanding of an overall picture of corporate value. In the midst of increasing importance of non-financial information, there is also a growing need for ensuring the reliability of such information. To achieve this, we need to assess the need for third-party assurance and its feasibility, along with the development of a reporting framework and standards (Topic 2) and interaction between corporate disclosure and corporate governance (Topic 3). We will discuss in detail the assurance of non-financial information in 4-3. Moreover, it is necessary to hold further discussions that pin down how audit and assurance should be performed, new roles of external auditors and how they should contribute to society, while deepening dialogue between companies and investors, as information preparers and information users, on the needs required to be met by audit and assurance engagements in order to realize corporate disclosure that underpins a sustainable value-creation cycle.

26 Auditing Standards Committee Statement No. 315 "Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment"

27 This will be adopted for audits for fiscal years ending on or after March 31, 2022. However, this can be early adopted for audits for fiscal years ending on or after March 31, 2021 (ASCS No. 720 "IV Effective Date").

28 In August 2016, IAASB published a Discussion Paper, "Supporting Credibility and Trust in Emerging Forms of External Reporting: Ten Key Challenges for Assurance Engagements". Then, it published a Consultation Paper "Extended External Reporting (EER) Assurance" toward the development of the guidance on EER assurance in February 2019 and the exposure draft of the said guidance in March 2020.

4-2 Strengthening communication and cooperation between external auditors and those charged with governance

In this topic, we will look at the need for external auditors to deepen their communication with the board of directors, especially with independent directors, while strengthening their coordination with the Board of corporate auditors, etc. in order to respond to changes in governance structures caused by recent events, including the development of the Corporate Governance Code.

Current state and issues to be addressed

4.6 Given the growing importance of the board of directors and independent directors in supervising the management of listed companies, as well as the need for external auditors to be involved in narrative reporting in the Annual Securities Report (ASCS No. 720, etc.), there is considered to be a growing need for external auditors to deepen their communication and coordination with the board of directors and its constituent directors (especially with independent directors who are required to be non-executive and independent). The Corporate Governance Code requires the board of directors and the board of corporate auditors to ensure adequate coordination with independent directors, as well as with external auditors, respective corporate auditors and the internal audit department (Supplementary Principles 3.2.2). Therefore, the challenge lies in how to specifically respond to this requirement in practice.

4.7 In this regard, whereas ISA 260 requires external auditors to communicate with those charged with governance, who oversee corporate reporting, ASCS No. 260 "Communications with Those Charged with Governance", in principle, names corporate auditors or the board of corporate auditors, the audit and supervisory committee or the audit committee as those whom external auditors should communicate with, while stating that "in Japan, the board of directors, corporate auditors or the board of corporate auditors, the audit and supervisory committee or audit committee fall into those charged with governance in accordance with the provisions for the establishment of organs in the Companies Act". The issue here lies in whether to include the board of directors (especially the chairperson of the board and independent directors) in "those charged with governance", whom external auditors are required to communicate with in the midst of a growing need for reflecting views of the board of directors in corporate disclosure as well as for the board of directors to perform the supervisory function.

4.8 With a company with three committees or an audit and supervisory committee, external auditors seek communication with audit committee members or audit and supervisory committee members, who concurrently serve as directors, in various forms in accordance with requirements set out in Auditing Standards and ASCSs. However, in Japan, the majority of companies adopt the structure of a company with a board of corporate auditors, in which the board of directors is not responsible for the supervisory function, because a body primarily responsible for the supervisory function is separated from a body primarily responsible for audit function in terms of institutional arrangement. In such companies, the board of directors is directly involved in decision-making on material themes, such as determining management policy and strategies, identifying material risks and material decision-making on investments including M&As, and responsible for supervising management. Meanwhile, the board of corporate auditors is responsible for auditing the execution of duties by directors. Accordingly, corporate governance in companies with such a structure is expected to function through the interaction between these boards. The disclosure of views on future management plan and investment decision-making has also become more important in financial reporting. As such, in the disclosure of narrative information that directly reports and explains such matters, it is vital for external auditors to share the recognition of the aforementioned material themes and deepen the mutual understanding with the board of directors, especially with the chairperson of the board and independent directors, which is charged with the oversight of management, as well as with corporate auditors by strengthening their communication with them.

Possible solutions

4.9 In the discussion by the Special Committee, given the recent emphasis on future orientation in corporate disclosure and the shift toward strengthening the management supervisory function of the board of directors, members reaffirmed that the board of directors is a vital organ that constitutes those charged with governance and shared the basic perception of the increasing need for external auditors to have more dialogue with the board of directors, as well as with the board of corporate auditors, etc. In the case of a company with board of corporate auditors, in particular, whereas external auditors are required to have communications with its corporate auditors and board of corporate auditors, they are not currently required to have communication with its non-executive directors. In view of this situation, we need to sort out issues in relation to external auditors' communication with independent directors, including objectives, key agenda items and timing of the communication. Based on such recognition, the Committee discussed the main topics, on which external auditors are expected to deepen the debate through the communication, taking into account the significance of these topics in terms of audit and governance (see Figure 14). In addition, we also need to discuss ways of tripartite cooperation involving corporate auditors and the board of corporate auditors.

Figure 14

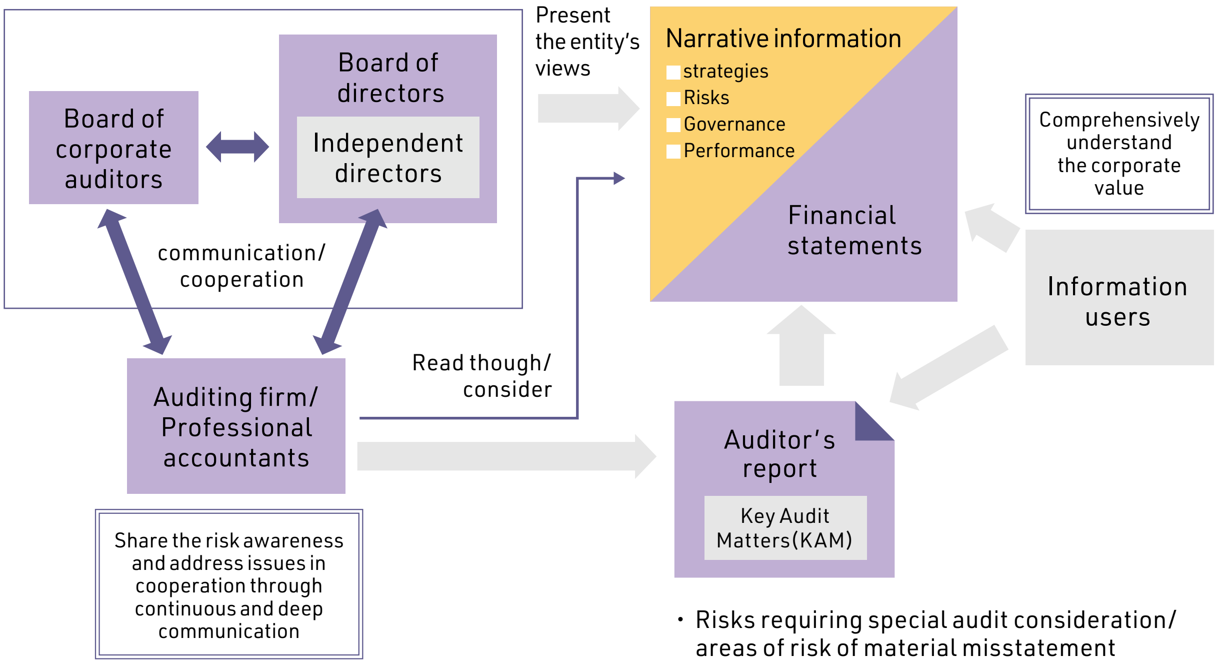
Proposed topics for communication between independent directors and external auditors

Topic	Significance in terms of audit	Significance in terms of governance
Views on management strategies, management plan and their progress	Reflected in the risk assessment in audits. Used for the evaluation of accounting estimates, such as goodwill.	Make use of opinions obtained from auditors to oversee management more effectively.
Material risk awareness		
Material projects and investments (current situation/outlook)		
Views on cost of capital	Used for assessing the discount rate setting.	
Development and operation of corporate governance	Used for the internal control evaluation.	
Division of roles and cooperation with the board of corporate auditors	Reflected in the communication with corporate auditors.	

4.10 The board of corporate auditors, etc. is responsible for the audit of the execution of duties by directors. Its roles include audits of directors' business execution and the entity's finance. Meanwhile, the board of directors is responsible for the entity's sustainable growth based on the authority delegated by shareholders. Its roles include the entity's strategic direction-setting and oversight of management. Taking into account such different roles and the relationships between them, it is important for external auditors to deepen communication with independent directors from the perspective of obtaining opinions from an independent standpoint while holding discussions with top management on the entity's strategies and their progress. Moreover, promoting tripartite cooperation involving the board of corporate auditors, etc. is key to improving the effectiveness of such dialogue. In light of the increasing scale and complexity of corporate activities, it is also vital for external auditors to cooperate with the internal audit department engaged in internal audits at the site on an ongoing basis. In a company with a board of corporate auditors, the audit function is separated from the supervisory function in terms of personnel. Therefore, it is highly necessary to explore best practices of such cooperation for companies with such corporate structure. In the meantime, even for companies with different corporate structures, it is also necessary to discuss the ways that external auditors cooperate with a body primarily responsible for the supervisory function and a body primarily responsible for the audit function, respectively.

Figure 15

Communication and cooperation between governance boards and external auditors



- Risks requiring special audit consideration/ areas of risk of material misstatement
- Judgments on accounting estimates, etc.
- Impact of material events and transactions

4-3 Reliability of non-financial information

In this topic, we will look at what roles should be played by external auditors and assurance practitioners in corporate disclosure as third parties in terms of ensuring the reliability of non-financial information. At the same time, we will categorize the nature of diverse information included in non-financial reporting and discuss the required responses, taking into account the need for and feasibility of assurance.

Current state and issues to be addressed

4.11 As the importance of non-financial information (narrative information) in corporate disclosure has increased, the reliability of such information has become an increasing concern. The reliability of non-financial information is assured when the following factors function together in combination: presence of robust disclosure documents (Topic 1), development of reporting frameworks and standards (Topic 2), development and operation of governance and process involved in disclosure (Topic 3) and audits and assurance provided by independent third parties.

4.12 Although the current framework for statutory audit of mandatory disclosure of financial information sets out the responsibilities of external auditors relating to "other information", such information is not subject to third-party assurance. Meanwhile, in some cases, practitioners perform assurance engagements with respect to information including certain indicators in Integrated Reports and other voluntarily prepared reports, in accordance with International Standard on Assurance Engagements (ISAE) 3000 "Assurance Engagements Other than Audits or Reviews of Historical Financial Information".

4.13 Internationally, discussions on assurance of non-financial information are picking up steam. In the EU, the European Commission proposed the CSRD, which requires statutory auditors to provide assurance engagements for non-financial information and express their opinions on such engagements in the auditor's report, in April 2021[29]. In March 2021, the EFRAG also published draft policies to present the principles of quality of information and reporting and laid out its plan to develop corporate disclosure standards to ensure the feasibility of audits. Prior to these publications, the Accountancy Europe released a position paper on high-quality non-financial information assurance in the EU in June 2020 to bring up the need for mandatory assurance, required assurance level and necessity of clarifying subject matter of assurance. The position paper also suggests the necessity of professional assurance standards applicable to all assurance service providers and including at least competence required for assurance, framework for quality management and independence requirements required for assurance practitioners in the standards. The IFRS Foundation proposed in the "Consultation Paper on Sustainability Reporting" that sustainability reporting standards to be set by ISSB should take into account the feasibility of assurance in anticipation of future external assurance. Furthermore, as mentioned above, IAASB published a guidance document on the assurance of "Extended External Reporting (EER)".[30]

4.14 Meanwhile, under the current practice in Japan, external auditors perform an audit of financial statements that are contained in mandatory disclosure documents. However, it is extremely rare that the auditor's report prepared by external auditors is attached to the financial statements contained in the voluntarily disclosed Integrated Report. In addition, assurance practitioners provide assurance for non-financial information which is part of non-financial information disclosed in voluntarily issued Integrated Reports. As such, in Japan, even if assurance are undertaken for some non-financial information, reports included in the scope of assurance are different from those included in the scope of financial statement audit. As a result, it is not generally the case in either of mandatory or voluntary disclosure that an annual report contains both audited financial statements and assured non-financial information. Such circumstances may not satisfy the needs of users who wish to comprehensively use both financial and non-financial information, and may even complicate the scope of information contained in mandatory and voluntary annual reports to be audited or assured. Amid a growing need for improving the reliability of non-financial information (narrative information), the issue lies in what kind of roles external auditors and assurance practitioners should play.

Figure 16

Comparison of assurance practices between Japan and other countries

	Japan	Overseas(mainly in Europe) Report for 2015-2016
Assurance provider	Divided roughly half-and-half between auditing firms and other institutions	Mainly provided by accounting firms
Scope of assurance/ assurance proposition	Partially assured Approach for scope setting: limited to specific indicators (e.g., greenhouse gas emissions)	Partially assured in most cases; completely assured in some cases Approach for scope setting: include all indicators while excluding future information Place a focus on process in many assurance engagements; emphasize stakeholders' point of view
Standard for preparation	Refer to an entity's own standards in most cases	Refer to standards of private standard-setting bodies such as GRI's guideline and AA1000
Other	Accompanies by experts' third-party opinion in many cases	
Subject of investigation	Reports for 2018 (Integrated Report) prepared by 66 companies	Reports for 2015-2016 prepared by companies participated in the IIRC Pilot Programme

Sources:
Assurance of Integrated Reports: a Comparative Study on Japanese and Foreign Cases (written by Taiki Okano in 2020), Current State of Assurance of Integrated Reports and Theoretical Study Thereof (written by Taiki Okano in 2018)

4.15 In the interviews conducted after the publication of the Interim Report, there was a view from some investors, i.e., information users, that in order to ensure the reliability of corporate reporting, not only financial information but also non-financial information should be included in the scope of assurance. On the other hand, some business professionals pointed out that inclusion of non-financial information in the scope of assurance may disincentive companies to perform active disclosure and result in superficial disclosures. It was also pointed out that, it is desirable to take an approach that specifies historical performance information, such as KPIs, as subject to assurance to ensure the reliability of disclosure information because assurance of future-oriented information, such as strategies and business models, may very well bring more harm than good.

4.16 In the interviews, some corporate managers questioned what kind of risks external auditors may have to take with respect to assurance of non-financial information and whether it is possible for them to take such risks. We were also suggested that what is important is not the act of providing assurance itself, but the fact that external auditors give a sense of confidence in disclosed information from an independent standpoint as guardians of the capital market, and facilitating in-depth communication between external auditors and top management and directors is key to making steady progress in introducing key audit matters (KAM) and responding to "other information" in disclosure documents.

Possible solutions

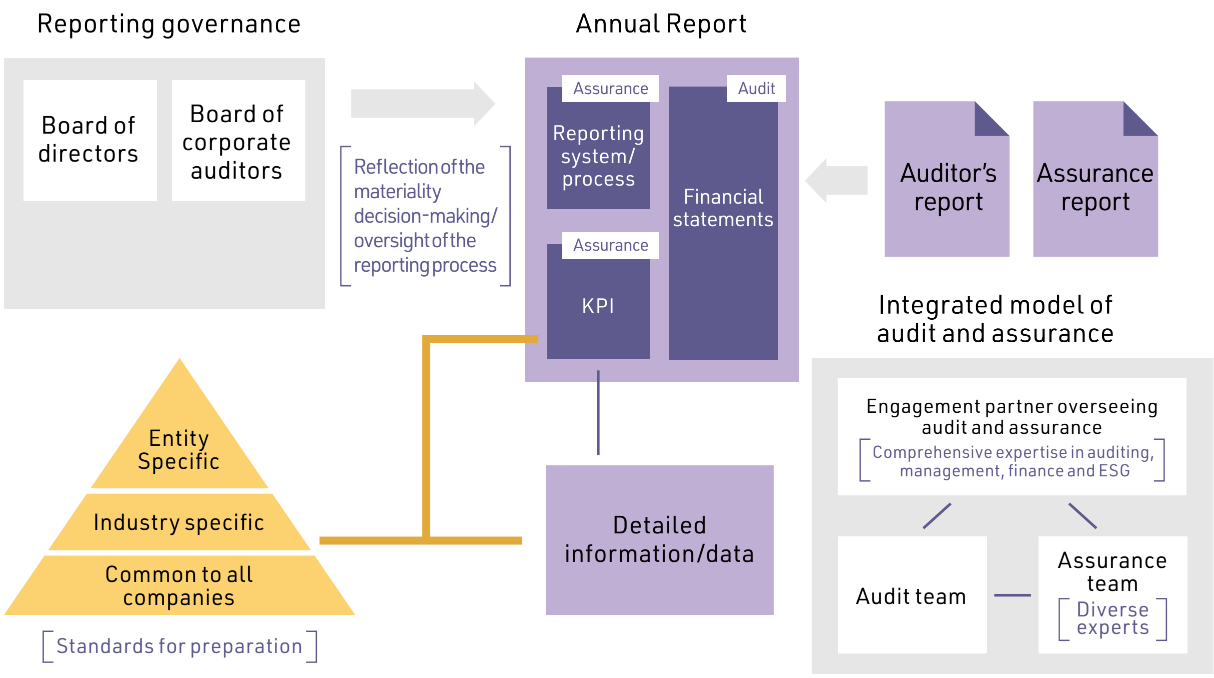
4.17 In light of the recent heated debates about assurance of non-financial information by third-parties, it is also necessary to proceed with a study on the way third-party assurance of non-financial reporting ought to be domestically, in addition to the development of standards for preparing information, interaction with corporate governance and development of internal controls, in order to enhance the reliability of non-financial information. In the study, we may face issues, such as, in particular, information to be assured, ensuring of the feasibility of assurance in preparation standards, bodies providing assurance (ethical standards including those for independence, required expertise, etc.) and interaction with financial statement audit. It is considered to be important to accumulate expertise in assurance engagements while addressing such issues in a practice of voluntary assurance, which has already adopted by an increasing number of companies, and proceed with international discussions and dialogues.

4.18 With an increasing call for enhanced connectivity between financial and non-financial information, the way of relationship and interaction between financial statement audit and non-financial information assurance ought to be is a major issue to be addressed. As efforts have recently been made to enhance narrative information in the Annual Securities Report, it is necessary to clarify the difference between "external auditors' responsibilities relating to other information" in the audit of financial statements and "independent third-party assurance over non-financial information". The former requires external auditors to consider whether there is any material inconsistency between other information and financial statements or knowledge acquired by external auditors in the course of the audit. Thus, the main focus is essentially placed on preventing disclosure of other information that may undermine the reliability of financial statements and the auditor's report thereof. Consequently, the objective of such engagement does not lie in ensuring the reliability of other information itself; and therefore, such information is not directly subject to assurance. On the other hand, the latter assurance of non-financial information is intended to ensure the reliability of non-financial information itself. Accordingly, before performing the engagement, assurance practitioners need to determine the scope of assurance by clarifying the subject matter and subject matter information so as to include "other information" in the assurance scope.

4.19 Assuming that information users, such as investors, comprehensively use both financial and non-financial information in combination, it is desirable that assurance engagements are also undertaken with respect to non-financial information contained in the same annual report as the audited financial statements. In such a case, while clarifying which information to be audited and which to be assured in the same annual report, an audit team and an assurance team are expected to cooperate each other to carry out their engagements with an awareness of the relevance and consistency between these kinds of information. It is also important that an auditor's report and an assurance report are provided in parallel in a manner that makes it clear to information users that which information in the annual report (scope of assurance) and how the reliability of such information is ensured (approach for assurance, assurance level). In Japan, we need to discuss whether it is possible to perform voluntary assurance engagements, especially for non-financial information disclosed in mandatory disclosure documents, and if it is possible, the scope of assurance and how the assurance report should be prepared.

Figure 17

Illustrative diagram of interaction between audit of financial statements and assurance of non-financial information



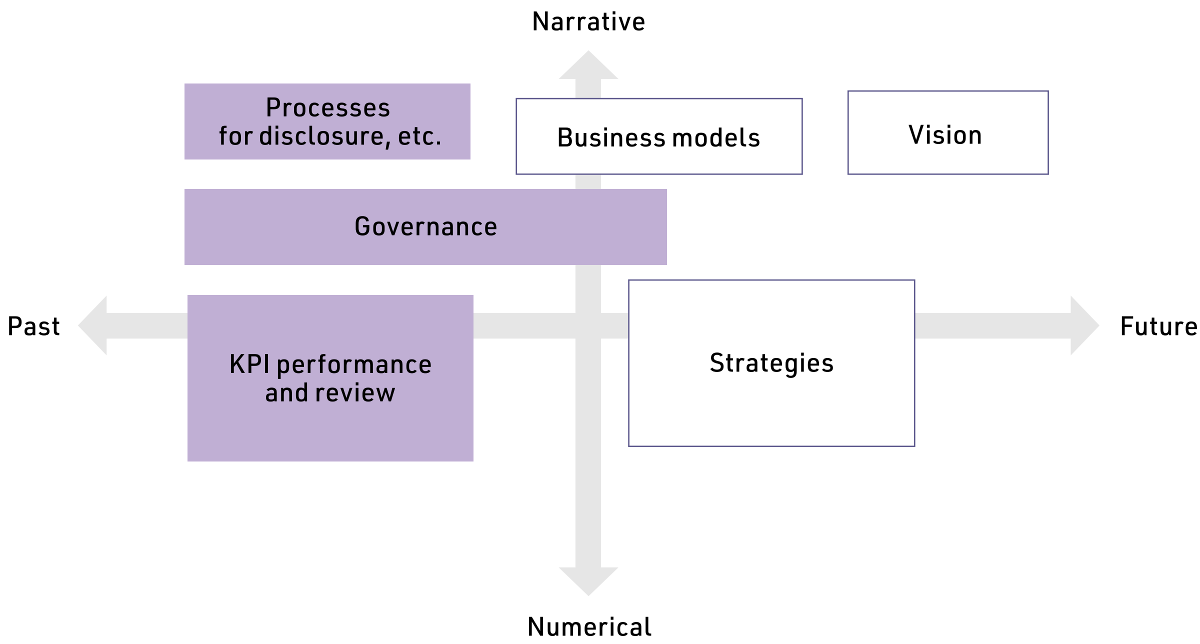
4.20 Non-financial information includes both past and future information and narrative and numerical information (see Figure 18). Among such information, there is a heightened need for assurance over past numerical information, such as historical KPIs. Therefore, we believe that development of reporting standards for recognition, measurement and presentation (standards essential to perform assurance engagements; see Topic 2) will increase the feasibility of the assurance. In the meantime, investors have great interest in information such as the process of corporate disclosure, including materiality determination (see Topic 3-2), as well as in information on the operation of corporate governance, including details of the board of directors' meetings held and their agenda items. Hence, if a framework is developed to explain such process and operation of governance in disclosure documents as past information, we believe that the feasibility of assurance for such information will also increase.

4.21 On the other hand, the disclosure of the entity's strategies and business model includes a lot of future information and such information expresses what the entity stands for. Therefore, careful consideration is required as to what kind of positive impact a third-party assurance will have on users. At the same time, it is also an issue whether it is possible to make an objective judgment on such information in light of specific standards. In particular, it is essential for third-party assurance not to be a restraint on companies' disclosure activities but to be an encouragement for their active disclosure while enhancing the quality of corporate disclosure through the establishment of the reporting governance process. In the interviews conducted after the publication of the Interim Report, the need for improving the quality of corporate reporting, which serves as the base for management's decision-making and external reporting, through the cooperation with external auditors and assurance practitioners, based on the awareness of a growing need for developing systems and processes to gather information from both domestic and overseas bases in a global and timely fashion and efficiently and effectively reflect such information in disclosure documents with consent of top management and the board of directors.

4.22 Also, issues that are particularly important in ensuring the reliability of non-financial information are how to assess whether the disclosure covers both positive and negative aspects in a balanced manner and how to respond to the risks of arbitrariness. Assurance practitioners are expected to assure that the views of the board of directors are reflected in disclosed information by examining the discussions by the board of directors.

Figure 18

**Difference in nature of non-financial information
(narrative and numerical information and future and past information)**



4.23 Based on the recognition that the extent of the need for and feasibility of assurance vary depending on the types of disclosed information, the Special Committee concluded in its discussion that the following three types of information, in particular, are likely to be in high need of improvement in reliability, and that they can be subject to objective judgment as past information in light of specific standards. Further study is needed on the need for assurance and feasibility of assurance, and further as to what kind of disclosure framework is necessary to deliver appropriate assurance engagements[31].

1 Assurance for numerical information on historical performance represented by KPIs (including Non-GAAP financial indicators) (Topic 1-3)

2 Assurance for information on operation of corporate governance (Topic 1-3)

3 Assurance for information on the disclosure process including materiality determination (Topic 3-2)

29 As to the level of assurance, upon the implementation of sustainability reporting in the management report in accordance with the CSRD, it is suggested to start with a practice where external auditors provide limited assurance engagements at the initial stage, then move on to reasonable assurance engagements once the assurance standards are developed. Although the CSRD requires statutory auditors to provide assurance engagements in principle, it incorporates a preferred option that allows the EU member states to authorize independent assurance services providers other than statutory auditors to carry out the assurance of sustainability reporting.

30 In April 2021, IAASB published a guidance document titled the "Non-Authoritative Guidance on Applying ISAE 3000 (Revised) to Extended External Reporting (EER) Assurance Engagements".

31 In conducting the study on the framework to improve the feasibility of assurance, it may necessary to examine the ways of disclosure that enable users to easily tell whether the information is subject to assurance or not (Topic 1-3) as well as constraints that may arise and criteria to be met when voluntarily performing assurance engagements for information other than financial statements, in addition to how the standards for measurement of KPIs and other indicators should be developed as discussed in this topic (Topics 1-3 and 2-1).

4-4 Enlightenment and capacity building of professional accountants

As corporate disclosure information becomes more diverse, it is now more necessary to ensure the reliability of such information, and to achieve this, external auditors are increasingly required to deepen communication with directors. In view of this situation, with this topic, we will look at what expertise professional accountants are expected to have as well as the need for raising their awareness.

Current state and issues to be addressed

4.24 External auditors are increasingly required by society to understand and assess the entity's business environment, business model, strategies and risks more than ever before. In addition, since the introduction of "key audit matters (KAM)" in the auditor's report, it has become increasingly important for external auditors to communicate with those charged with governance, while being required to provide greater transparency about the audit. The enhancement in the disclosure of narrative information in Annual Securities Reports may have led to higher expectations by information users for responses by external auditors, including through-reading of other information in disclosed documents. When looking at such relevant movements from a bird's-eye view, we can see a growing need for external auditors to raise their awareness and deepen their understanding of non-financial information.

4.25 Given the rising importance of communication between external auditors and top management and directors in an audit and more provision of voluntary assurance as well as the increasing number of professional accountants serving as independent directors, professional accountants are now more required to have expertise on subject matters, such as management strategies, risk management and corporate governance. For example, in recent years, the Institute of Chartered Accountants in England and Wales (ICAEW), a professional membership organization of accountants in the UK, has been seeking to enhance its educational program for its students and members with a focus on themes such as management of business, corporate governance and sustainability as areas of expertise for Chartered Accountants (see Figures 19).

Figure 19

Non-financial areas in ICAEW's education syllabus

Area	Item/details
Business Strategy and Technology	1. Strategic analysis • Impact of cultures and systems on business models • Reflection of non-financial factors in strategic management • Indemnification, gathering and management of information to create competitive advantage 2. Strategic choice 3. Implementation and monitoring of strategy
Financial Management	1. Financing options 2. Managing financial risk 3. Investment decisions and valuation
Business, Technology and Finance	1. Business objectives and functions 2. Business and organisational structures 3. The role of finance 4. The role of the accountancy profession 5. Governance, sustainability, corporate responsibility and ethics 6. External environment 7. Technology
Management Information	1. Costing and pricing 2. Budgeting and forecasting 3. Performance management and management information operations • The roles of financial and non-financial KPIs • Incorporation of KPIs into management controls and governance 4. Management decision making 5. Ethics

Source: Prepared based on ACA Syllabus Handbook 2020 by ICAEW.

4.26 Additionally, professional accountants are increasingly required to capture the needs of not only information users but also capital markets as a whole. The increased volume of information using accounting estimates in financial reporting and the introduction of KAM have led to the growing need for external auditors' professional judgment in many situations. On the other hand, non-financial information is required to be disclosed in ways that reflect the materiality of specific information (based on guiding principles such as IIRC's International Integrated Reporting Framework and the Principles Regarding the Disclosure of Narrative Information); and therefore, external auditors are not directly required to express their opinions in an entity's assessment of materiality. However, when reading through and examining "other information" to address inconsistency or material misstatement of fact, it is vital for external auditors to understand what investors are interested in or concerned about.

Possible solutions

4.27 Now we are facing an increasing need to reidentify the expertise required for external auditors, taking into account the recent changes in the environment surrounding corporate disclosure, unmet needs required to be met by audits, and further, the expanding sphere of professional accountants' activities in companies as independent directors or independent auditors, or professional accountants in business (PAIB). Professional accountants used to be positioned as experts in financial accounting and audit. However, they will now need to enhance their comprehensive capabilities in a whole range of themes relevant to corporate management by developing expertise in themes such as business strategy, risk management, performance analysis and assessment, corporate governance and sustainability — not to mention the need to further enhance their expertise in corporate finance in general.

4.28 In order to meet such societal needs, we need to review the existing education system for professional accountants. In the current system in Japan, the level of professional accountant's competence and expertise is ensured through programs like the CPA Examination, the professional accountancy education program and the Continuing Professional Education (CPE) program. Such programs will now need to develop a new policy direction toward enhancing their education in themes, including management strategies, risk management, corporate governance and sustainability, and sufficiently reflect the focus on these themes in their education syllabus. Moreover, in order to promote constructive dialogue between external auditors and directors, it is also necessary to share the information mentioned in Topic 4-2, such as key agenda items for such dialogue, with professional accountants who work as engagement partners in audits as well as those who serve in positions as independent directors and independent auditors in companies.

4.29 Recently, assurance engagements for non-financial information have been increasingly undertaken. Among various non-financial information, some kinds of information such as climate change and other environment information and human capital-related information, require highly specialized expertise in areas, including natural science and human rights, in the course of their preparation and assessment. Against this backdrop, in voluntary assurance engagement for Integrated Reports and other voluntary reports, professional accountants specialized in finance and accounting and audit usually team up with other experts and jointly undertake assurance engagements. As such assurance engagements are expected to be more commonly performed in the future, it is necessary to move forward with initiatives to facilitate effective coordination between professional accountants and other experts.

4.30 In recent years, companies have become more compelled to promote dialogue with investors. At the same time, it is also more required for professional accountants, who provide auditing and assurance services for information disclosed to investors, to deepen their understanding of a wider range of investors' needs and concerns. As seen in phenomena such as the increase in passive investors, the widespread adoption of stewardship behavior and responsible investment by investors and the increasing popularity of new investment methods using AI and other technologies has resulted in rapid changes in investors' behavior. Amid such an environment, it is also vital for professional accountants to adapt to these changes in a timely fashion. In this respect, we need to make further efforts to create more opportunities for dialogue between professional accountants and investors to deepen their mutual understanding in order to achieve more timely sharing of necessary information.

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