Research Report No. 59, Management Study and Research Committee

How can corporate reporting practice support long-term oriented behaviour of institutional investors?

—Consideration with focus on non-financial information—

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Japanese Institute of Certified Public Accountants

Executive Summary

Ⅰ Recent Trends and Issues about Corporate Reporting

Corporate reporting is currently going through a significant transformation on a global basis. Japan is no exception, where significant policies, such as deregulations, have been implemented to unlock private sector entities' ability to create value. Amid such an environment, both companies and institutional investors that constitute the capital market are required to transform their mindset to achieve optimal resource allocation in the whole investment chain from a long-term perspective.

To realize sustainable value creation through the most suitable resource allocation over the long term in the capital market, it is necessary to secure an environment for investors where they can evaluate enterprise value from a long-term view and take actions as needed based on information disclosed by companies. Corporate reporting also plays an important role in providing information which forms the basis of dialogue between investors and companies so that they can have a better understanding of each other.

We have certainly seen some changes on the companies' side. More companies have recently started to place a high value on investors that make investments from a mid- to long-term perspective. In Japan, the number of companies issuing integrated reports is increasing year by year. We understand that companies are providing such reports to attract investors with longer-term views through sharing their corporate value over the mid- to long-term.

However, it appears that both companies and investors are still facing many challenges in the practice of corporate reporting, in which non-financial information plays an important role in effectively communicating mid- to long-term corporate value. That being said, the purpose of this Report is to provide recommendations on corporate reporting practice so that it can contribute to the decision making of investors who undertake their investment activities from a long-term perspective.

Ⅱ Investor Behaviour and Needs for Information

This Report aims to provide insight on corporate reporting that is useful for investor activities from a long-term perspective. In this Report, we regarded institutional investors as the intended users of corporate reporting, who conduct investment activities based on companies' fundamental factors which determine the intrinsic value of shares, including financial condition and results of operation. This Report focuses on analyzing the information needs of those institutional investors.

Institutional investors are organized investors with stewardship, who invest on behalf of their members. Therefore, they tend to seek decent returns, which represent financial returns consisting of income gains (dividends) and capital gains (gain on sales), to bear their investment risks. Institutional investors use various means of analyzing and evaluating companies, but whichever method they use, we need to understand that their ultimate purpose is to identify potential financial risks and returns arising from the investment.

The operational process taken by institutional investors is mainly composed of the following: developing the investment universe; evaluating values of potential investee companies; developing portfolios; and conducting engagements with investee companies. Active funds follow the entire process, whereas passive funds do not evaluate individual enterprise values, but instead, develop portfolios by selecting specific investment indexes to which the investment funds will be linked.

Investors carefully take account of numerous factors affecting the future financial return of investees throughout the entire operational process of investments. We have analyzed such operational process of investments and interviewed investors to summarize the information need of institutional investors seeking long-term investment and the type of disclosures fulfilling the need of such institutional investors.

Information needs of institutional investors seeking long-term investments

- Information useful for the financial evaluation of enterprise value
- Information representing the quality of governance

Characteristics of disclosures fulfilling the need of institutional investors seeking long-term investments

- Disclosures appropriately representing entity-specific situations
- Disclosures providing management commitments, which can be evaluated for their progress and outcome
- Comprehensive and logical disclosures enhancing investor confidence
- Disclosures supporting evaluations based on long-term perspectives
- Disclosures supporting efficient use of information

Ⅲ Corporate reporting that supports long-term oriented behaviours of institutional investors

1. Information highly valued by institutional investors seeking long-term investments

1-1. Disclosures useful for the financial evaluation of enterprise value（fig. １）

When investors evaluate the enterprise value of companies, they need to estimate the future financial return from the investment and determine the capital cost by projecting the future cash flow and assess the potential risks associated with the company, which are derived from its current financial condition, including capital structures, and operating results. For corporate reporting purposes, it is essential to understand not only such investors' attitude and process of evaluating enterprise value, but also major non-financial information required for the financial evaluation, such as the following.

(1) Disclosures useful for the evaluation of productivity, growth potential, and risks of a company

When assessing the future financial return based on a medium- to long-term financial forecast, the productivity and growth potential of the company are key. The sustainable growth of the business can be achieved by enhancing the productivity over time.

Uncertainty is inevitable for businesses. In order for the investors to incorporate the business uncertainty in the corporate value assessment, it is important that the information allows for an assessment of the medium- to long-term risks of the company be disclosed.

(2) The company's long-term vision and business model as well as the driving forces behind them

The medium- to long-term productivity and growth potential of a company depend largely on the future business model of the company. An effective business model can be described as mechanism for creating the values for the society at large in the future economic, social and competitive environments by taking advantage of the company's competence and generating profits, and hence a financial return for the investors. For the investors to understand the future business model of the company, the corporate mission, vision and values are essential.

(3) Disclosures about the company's strategy which shows a journey to the future (policy and plan for the resource allocation)

Success of the business model depends on the strategy of the company. We defined the strategy in this report as a method, or approach, to realize the effective business model the company seeks to establish by optimally allocating and leveraging various business resources and relationships of the company including human, physical, financial and other capitals. It is without saying that the intangible resources are getting more and more important for the businesses.

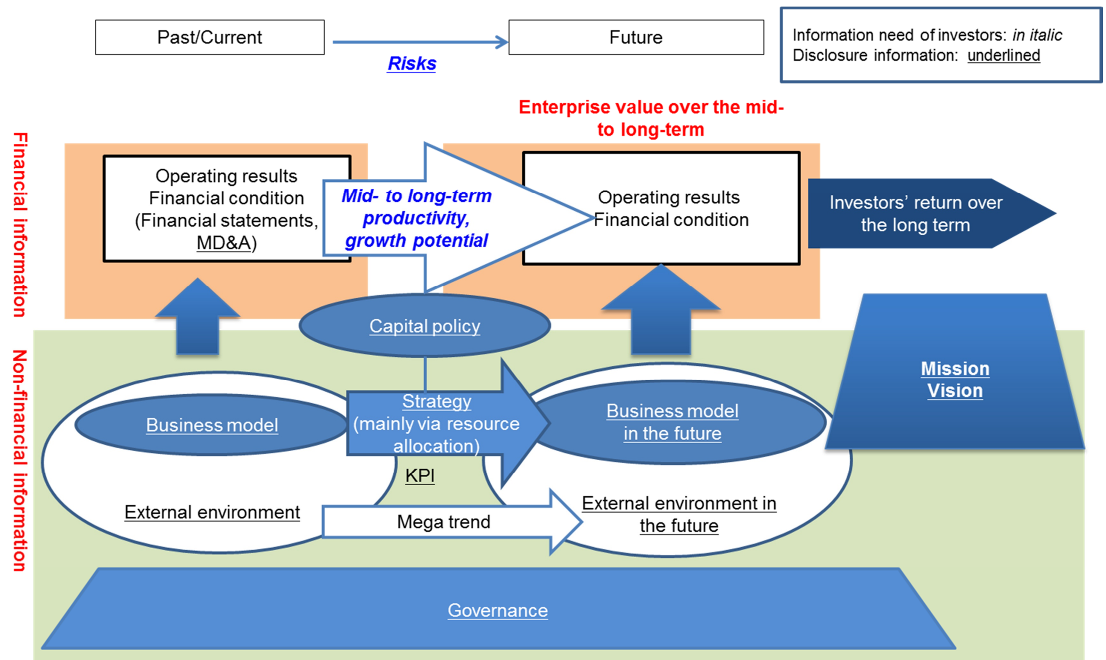
(4) Explanation of the company's capital policy

Stable corporate financing is fundamental for the effective and proactive investment for the future. The capital policy includes the principle of the capital structure, capital cost and the policy concerning retention of earnings and dividends.

[Figure1] Disclosure information useful for the financial evaluation of enterprise value

1-2. Information indicating Quality of governance

Institutional investors seeking long-term investments generally place high value on companies' information regarding their quality of management and governance as a basis for dialogue with the company and also as part of shareholders' responsibility. In addition, more institutional investors are



systematically analyzing the quality of corporate governance when developing portfolios.

Although we see significant improvement in the quality of disclosures related to corporate governance through a series of regulatory reforms, some investors pointed out that they still see many stereotype disclosures, which do not seem to provide enough explanation to investors as to how corporate governance is developed by a company to enhance its ability to create value over time. Investors are seeking credibility as to the quality of their corporate governance. Therefore, we recommend the following to be considered by companies to improve their disclosures.

(1) Explaining corporate governance logically as to how it is designed to support company's value creation over time

The companies are expected to explain in a systematic way how the governance structure is designed to support their sustainable value creation process. The governance structure includes the institutional arrangement, composition of the governing board, the management policy, compensation policy, engagement policy with shareholders and other stakeholders, and the accountability policy. It is key that the design and operation of those governance elements are explained with the fundamental policy the governance structure is built, for the purpose of creating medium- to long-term sustainable values.

(2) Aligning corporate governance with the company's business model and strategy

In assessing the effectiveness of the governance structure, the investors are extremely interested in the question of whether the governance structure of the companies is consistent with their business model and strategy, or not. From the view point of focusing on long-term value creation, it is expected that the director compensations are designed to ensure sustainable productivity and not overly structured as short-term incentives.

(3) Providing updates on the operation of governance

In addition to how the governance structure of the companies is designed, the investors are extremely interested in whether the governance structure thus built is effectively operated.

2. Characteristics of disclosures that provide useful information

2-1. Disclosures representing entity-specific situations

The financial value of a company is largely dependent on its business model and strategy. Investors understand that business models and the external environment surrounding companies are diverse and, therefore, they appreciate information that specifically depicts the circumstances of each company.

The good news based on our interview is that investors increasingly acknowledge that more companies are starting proactively to use voluntary-disclosed annual reports to effectively communicate their value creation process. The bad news, though, is that we found out that many investors are still frustrated about companies' information disclosures, especially those related to corporate governance, risks and KPIs (Key Performance Indicators), as such information seems to lack uniqueness or diversity in many cases.

The following consideration should be given by companies to appropriately disclose information representing entity-specific situations.

(1) Connectivity with the context of a company

For the investors to effectively assess the robustness of the business model and strategy, it is also key that they are informed of the mega-trends that form the basis of the business model. Similarly, the information on the corporate governance, risks and KPIs can be supported by concise background explanation of the facts and management view.

(2) Materiality determination and disclosure

In order that the company-specific situations are reflected in the disclosure and their own value creation stories are communicated, the companies need to effectively determine material issues to be reported. By disclosing companies' policies on materiality and the materiality determination processes, it is expected that companies will enhance the credibility of the information to the investors.

(3) Balance between comparability and strategic focus

The comparability of the information is considered more in demand for the purpose of rating the companies or of analyzing data encompassing many companies, rather than for providing an assessment of the value creation ability of individual companies.

On the other hand, there is a view that it is not necessary that all the companies disclose the standardized indicators uniformly to ensure comparability, if relevance and materiality of entity specific information would be sacrificed.

2-2. Disclosures providing management commitments, which can be evaluated for their progress and outcome

Strategy is an essential part of the information for investors to evaluate the enterprise value of a company from a mid- to long-term perspective. It appears that many companies explain their future visions; however, not many companies are disclosing their strategic objectives as their managements' commitment for the future. In addition to such clear commitment, our interviews show that investors are expecting companies to include more analysis and narrative explanation of the performances for a better understanding of companies' progress towards their strategy.

The following consideration should be given to developing KPIs about the purpose of disclosing such information in relation to the company's strategy and how to provide more effective KPI disclosures.

(1) KPIs that reflect major components of operating results and strategy of a company

The KPIs should reflect the corporate performance and key strategic elements. Accordingly, indicators the companies select and disclose are important in order for the investors to understand the corporate strategy.

(2) Effective mix of financial and non-financial indicators

The KPIs should comprise financial (mainly business performance-related) and non-financial (mainly strategy-related) indicators, and these two types of indicators should be linked together organically by the strategy.

(3) KPIs that are measurable objectively and continuously

The KPIs are a means for regularly observing the corporate performance and progresses of the strategy, and should be observable objectively and continuously. Certain indicators that objectively show the level of progresses are required as information to be incorporated in the investment analysis.

(4) Management explanation about the reasons for choosing specific KPIs as well as disclosures of KPI analyses and the results

When the KPIs are disclosed, it is important that the grounds for the choice, relationship with the management strategy and measurement methods are shown.

Concerning the actual results and progress status of KPIs, the explanation of the backgrounds, analysis and assessment results from the viewpoint of the management will help investors have deeper insight into the progresses in the strategy and management issues.

2-3. Comprehensive and logical disclosures enhancing investor confidence

Investors are looking for reports that are logically prepared and disclosures that show the entire picture of a company. In other words, many investors are not satisfied with current corporate reporting practice, which sometimes seems to lack logic or comprehensiveness.

Regarding the logic issue, investors have pointed out the following: more explanation can be provided along with evidence about the company's understanding of environment surrounding its business model; and the relationship between the company's strategic policy and management plan is not always clear in the report. Speaking of comprehensiveness in corporate reporting, investors insist that it is not unusual to see disclosures focusing on specific events or actions with little explanation about how they are related to the company's overall strategy or management plan.

The following points should be considered in corporate reporting to provide comprehensive and logical disclosures in order to enhance investor confidence.

(1) Comprehensive disclosures depicting the entire picture of a company's business

It is essential that the information disclosed shows the full picture of the business model, strategy and business performance of the company, rather than part thereof.

(2) Actual numbers corroborating such disclosures

The investors make investment decisions using analysis of the corporate value in the amount. Therefore, it is important to disclose both quantitative and qualitative information, which supports the feasibility of the strategy and adequateness of the analysis and assessment, for the future-oriented information such as strategy as well as for the past information such as business performance,

2-4. Disclosures supporting evaluations based on long-term perspectives

Information disclosure on time frames is also an important factor when evaluating enterprise value from a long-term perspective. It is essential to provide such information so that investors can incorporate long-term issues in making their investment decisions.

Information related to basic policies and management decision-making, such as assumptions and methods used in compiling objectives and action plans, will be useful for investors who need to evaluate enterprise value from long-term perspectives. Such information includes the following.

(1) Disclosures on a company's vision and strategic policies

In order to support the investor behaviour with a long-term perspective, it is necessary that the companies disclose not only the information on the medium-term management plan but also the corporate vision and strategic policy. With the presentation of such long-term vision and strategic policy, it is possible for the investors to assess the significance and rationality of the medium-term action plans.

(2) Clarification of time frames

When explaining matters related to the future, it is important that the company clarify time frames so that investors can assess whether the vision or strategic goals are in line with the social and economic environments in the future and/or whether they are achievable in consideration of the current situations of the company.

2-5. Disclosures supporting efficient use of information

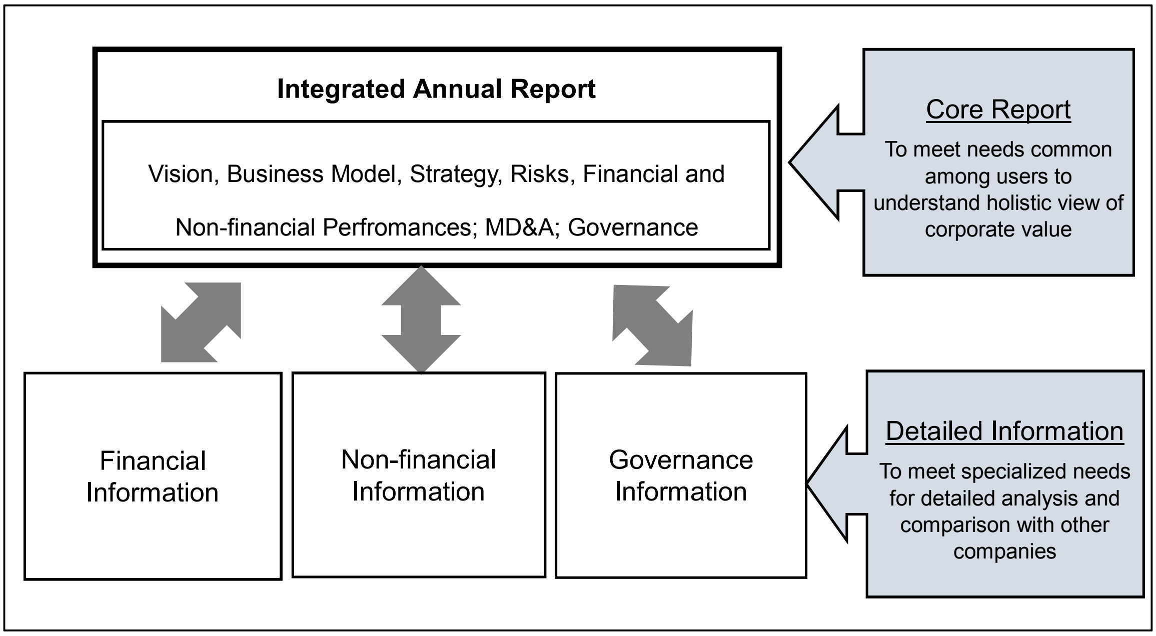
In Japan, companies disclose their annual reports and CSR reports on a voluntary basis in addition to regulatory disclosures. Due to the nature of such voluntary disclosures, there is a wide variety in respect of their content, structure and the volume of information. In addition, disclosures can be provided in different media, such as printed paper or electronic data. Investors are pointing out that such wide range of disclosures are making it more difficult for investors to use and analyze information efficiently.

Considering the basic need of a wide range of investors, we recommend that companies first prepare the main report, in which significant information is provided comprehensively, and then communicate other detailed information or issues through company website or other media for the sake of specific users. The following points should be considered for disclosure purposes.

(1) Structured disclosure media(fig.2)

In order for investors to understand the full picture of the corporate value, reporting needs to be systematically structured. It is important that key information is concisely and completely disclosed in a single core report, integrated annual report, and references (mutual links) with other detailed information, both within a medium and between media, need to be made.

[Figure 2] Systemization of Reports



(2) Component and structure of the core report

In order to enhance the usability for the users, the core report should contain major elements such as corporate philosophy, vision, business model, strategy, risks, financial and non-financial results, MD&A and governance, and be constructed so that the flow or relationship between the elements is easy to understand.

(3) Logical and concise disclosure

The explanations in the report should be constructed so that readers can follow the flow effectively. For this purpose, it is desirable if the report is organized logically, clearly positioning the various information pieces such as policy, (action) plans, facts, results, perception and assessment. Further, the information to be disclosed should have the materiality and logicality that can influence the corporate value assessment.

Ⅳ Improving environment for a more useful corporate reporting

Investors have pointed out that improvements are required not just in terms of companies' practice but also involving the structure of corporate reporting system, investors' attitude and reporting frameworks. We suggest the following, based on the interviews, regarding the improvements as well as necessary actions for more effective corporate reporting practice.

1. Corporate reporting system: A need for an integrated disclosure system

Many investors pointed out in the interview that there are too many disclosure-related documents in Japan with scattered information, which often makes it difficult for investors to find and pull together the information they need within a limited time frame. More specifically, some investors insisted that disclosures under the Companies Act, Financial Instruments and Exchange Act and stock exchange regulations should not be made in various documents or forms, but instead, should be compiled into an integrated annual report, with detailed reports or statements linked. A careful consideration should be given as to how a reporting system can support and ensure an environment where investors can utilize information more efficiently.

The Corporate Governance Code also plays an important role in corporate reporting, as it adopts a principles-based approach, under which disclosures on management policies, allocation of resources in relation to management strategies, the oversight by board of directors, and so forth are required. Such an approach, under which management policies and strategies are centered around reporting, is consistent with the framework of principles-based corporate reporting. Given the circumstances, we need to establish an environment where companies can effectively disclose significant non-financial information in their statutory reporting documents. In other words, we need to consider the possibility of adopting a reporting system which allows companies to challenge more innovative and proactive reporting practices. We may also need to think about necessity of Safe Harbor Rules to minimize companies' litigation risks by disclosing future-oriented information.

2. Change in investors' attitude and actions

Japan's Stewardship Code requires institutional investors to enhance their capabilities of understanding the value of companies and develop their policies and procedures to appropriately utilize non-financial information. There are also certain investor communities showing keen interest in corporate reporting and proactively engaging with companies.

As we have already discussed above, companies are highly expected to have a better understanding of investors' information need for corporate reporting purposes in order to provide more useful information to them.

At the same time, proactive communication is also expected from the investors' side, such as by proposing to companies the type of information or disclosures they need and by recommending improvements in companies' practices.

One-on-one communication between companies and investors is not enough, though. As we are seeing some institutional investors already working together to tackle the disclosure issue in Japan, it is imperative to aggregate and realize investors' feedback for a better corporate reporting practice. We expect that such movement will continue and gain widespread support among other investors.

3. Development of frameworks and standards for corporate reporting

Frameworks and standards for corporate reporting that reflects investors' need should also be developed. In this Report, we have provided some suggestions for an effective disclosure based on our understanding of investors' decision-making activities and information need.

In recent years, international frameworks and standards incorporating non-financial information disclosures for the use of investors have been developed. The International Integrated Reporting Council, the IIRC, issued The International <IR> Framework in 2013 and proposed the companies' value creation over time as a core of corporate reporting to the providers of financial capital. The IASB Management Commentary and industry-specific standards developed by the Sustainability Accounting Standards Board (SASB) also provide useful frameworks for communicating non-financials to investors. However, there is still a long way to go, as inter-relationships among the frameworks and standards are not clear yet, and also it is expected to those initiatives to bridge the gaps and minimize the overlaps to enhance the consistency. These circumstances are making it more difficult for companies to perfectly comply with all of the standards and guidance at the same time. Therefore, on a going forward basis, we highly recommend that organizations to accelerate the pace of processes and works toward a more coherent and complete corporate reporting system by collaborating with each other.

In addition, it is imperative to develop informative KPIs for effective use by investors. We would like to point out that not only is there a need for consideration to develop KPIs but we may also have to think about converging KPIs by industry and/or region.