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TSE Relaxed Earnings Forecast Disclosure Rules

Disclosure made more flexible, but dialog emphasized

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Summary

- On 23 Mar 2012, TSE relaxed rules for listed firms' earnings forecasts.

- Firms were required to provide 1H, full-year forecasts for next-FY sales, op profit, rec profit, net income, EPS, dividends. Firms now have more flexibility to choose which items to include, how to present items, which periods to cover,etc. Changes intended to steer firms preparing disclosure in direction of dialog with investors rather than perfunctory conformation with rules.

- Relaxed rules to come into effect with financial statement filings with TSE for FY ended Mar 2012.

1. Circumstances surrounding review

On 23 March 2012, The Tokyo Stock Exchange (TSE) published a report on the practical treatment of earnings forecast disclosure (report dated 21 Mar; hereafter *Practical Earnings Forecast Disclosure*).

An 18 June 2010 Cabinet decision on a new growth strategy called for examination of how earnings forecasts are presented on stock exchanges as a priority element (undertaken in FY10) of the financial strategy.

On 20 July 2010, Japanese business association Keidanren published a report on revisions to Japanese disclosure rules for financial statements. The report pointed out that earnings forecasts have become less useful because Japan already requires timely disclosure of performance through quarterly financial statement filings with the TSE (*kessan tanshin*) and other statutory quarterly reports. It further called for authorities to consider abolishing earnings forecasts or making them completely voluntary and revising the format of *kessan tanshin*, bearing in mind the overall contemporary significance of forecast disclosure and the business burden imposed.

On 29 July 2011, the TSE responded by publishing a report examining listed companies' disclosure of earnings forecasts. The report was put together by the Japan Securities Research Institute (Institute's report, not TSE's).

The TSE's Advisory Group on Improvements to the TSE Listing System discussed disclosure requirements on 28 October 2011. The TSE then published its policy on revising requirements to handle earnings forecast disclosure in a practical manner on 28 December. The basic policies contained in the report are as follows.

1. To establish requirements allowing for the disclosure of diverse future estimates relevant to companies' circumstances while taking into account investors' needs, thereby creating a flexible earnings forecast disclosure system compatible with the changing environment in which companies operate
2. To abolish the following provisions, which could be understood to effectively compel disclosure of sales, profit, and other earnings forecasts:
   - Prior discussion with the TSE before omitting earnings forecasts or publishing forecasts in a non-standard format
   - Disclosure of reasons for above
3. To ensure relevant parties have sufficient knowledge of the purpose of the rule changes to ensure fair disclosure and prevent reversion to simplistic disclosure

On 21 February 2012, an independent subcommittee of the TSE's advisory group, headed by Etsuro Kuronuma of the Waseda Law School, convened to consider specific *kessan tanshin* formats allowing for more flexible earnings forecast disclosure. I, as a member of the subcommittee, provided the perspective of a user of financial statements, reporting on the results of interviews with securities analysts and institutional investors.

These discussions culminated in the TSE's release of *Practical Earnings Forecast Disclosure*

2. Outline of *Practical Earnings Forecast Disclosure*

(1) TSE's basic view on disclosure of future estimates

Practical Earnings Forecast Disclosure contains the following fundamental principles

- The TSE will continue to require listed companies to proactively disclose future estimates useful for investors' investment decisions (information relating to company's outlook for future business performance and financial position)
- Disclosure of such information will not be limited to the "forecasts for the next fiscal year" presentation in *kessan tanshin*.

The TSE wants listed companies to continue proactively disclosing future estimates to bridge the serious information gap between investors and the listed companies, which have the most detailed and accurate information regarding the state of the company and its future business strategies, and to engage in a substantial dialog with investors in order to support fair and smooth price formation in the securities market.

In practice, the method outlined below has been widely adopted to disclose future estimates (used by around 97% of listed firms in survey of *kessan tanshin* for FY ended Mar 2010). The TSE clarified that disclosure of future estimates is not limited to this method.

1. presenting forecasts for sales, operating profit, recurring profit, net income, earnings per share, and dividend per share
2. for the next fiscal year
3. in full-year *kessan tanshin*
4. as earnings forecasts for next fiscal year

Listed companies' future estimates can include a wide range of information, including descriptive explanations of a company's outlook, forecasts of major business indicator such as ROE, and forecasts of financial indicators affecting future business performance (e.g., capex, R&D spending, depreciation expense).

The TSE abolished the requirements, listed below, previously effectively imposed on a company augmenting or revising forecasts for the next fiscal period, or omitting those forecasts (further details in TSE report)

- Prior discussion
- Statement of reasons

(2) Revised rules

Revised format (summary data)

A listed company can choose to present earnings forecasts, in a tabular form or an alternative format of the company's choosing, in the *kessan tanshin*'s first page summary section, to suit the company's circumstances.

A sample table includes 1H and full-year forecasts for the next year's sales, operating profit, recurring profit, net income, earnings per share, and dividend per share. However, companies can add or delete line-items, use a different format (present range of values defined by upper and lower limit), or use different periods (full-year, half-year, quarters) to suit their circumstances if, for example, significant changes in the operating environment make forecasting annual performance difficult and a company does not have reasonable forecasts for some or all line-items.

The following examples of augmented or altered forecasts were provided.

- Full-year forecasts only because company manages performance on an annual basis
- Full-year forecast presented as a range because of severely fluctuating prices
- Next-quarter forecasts presented as a range because of difficulty forecasting 1H or full-year earnings amid a severely unstable operating environment
- Full-year net income forecast only in the summary section of the *kessan tanshin* (together with forecasts for industry-specific financial benchmarks in separately prepared supplementary materials relating to results)
- Sales forecast only because of rapidly deteriorating visibility in the operating environment

In our discussions with sell-side (securities house) analysts, almost two-thirds of them criticized disclosure of different items or items for different periods. Some business people and experts said they would like to see recurring profit replaced with capex and depreciation. Sell-side analysts criticized disclosure for short periods (particularly quarters) for being misleading because of seasonality and reinforcing short-term thinking.

To prevent companies using the freedom to present data in non-tabular form to simply provide no information at all, companies will be required to clearly and concisely record any information contained in results announcements that the company considers useful for investors in making investment decisions. Information useful for investors' investment decisions includes forecasts such as future dividends and earnings and factors pertaining to the company's ability to continue as a going concern. Examples include, but are not limited to, estimates of major business indicators and descriptive explanations of the company's outlook based on the company's own circumstances.

The following examples illustrate non-uniform disclosure.

- Qualitative description of information likely to be useful in forecasting future performance
- Forecasts of business or financial indicators likely to be useful in forecasting future performance

When forecasts are provided in supplementary statements to *kessan tanshin*, supplementary materials to financial statements, and results briefing materials, summaries could also be recorded in the free-description field.

Other practical considerations

Other considerations include the following

Other Practical Considerations **Chart 1**

Item	Considerations
1. Encouraging dialog with investors	Firms should engage in full dialog with investors (incl. intermediaries such as securities analysts, media) when planning how to present forecasts. Proactive, sustained communication with investors aimed at developing mutual understanding of firm's circumstances and investors' needs is desirable.
2. Presenting fair forecasts	On 28 Mar 2006, TSE informed listed firms that earnings forecasts should be fair, in response to incident in which a listed firm's financial statements contained false entries. Firms required to calculate forecasts in reasonable manner and guide investors to use information appropriately.

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	TSE's notice specified the following: 1. Forecasts for each segment, management strategies with potential material impact on earnings, and other background information should be specifically stated in *kessan tanshin* (qualitative statements) 2. Clear cautionary statements should be made regarding use of future estimates, incl. explanations of risks for performance to deviate significantly from forecasts 3. Firms should quickly review and revise forecasts upon occurrence of subsequent events potentially affecting performance
3. Points to consider when not presenting earnings forecasts for following period	**a. Need appropriate understanding for timely disclosure of forecast revisions** - Even when no earnings forecasts for next FY provided in *kessan tanshin*, a company must immediately disclose[1] any information that exists within the company and suggests earnings will differ from previous year's results[2]. Newly calculated forecasts made during the period must also be disclosed if they deviate from prior-period results even if deviation of initial forecasts from prior-period results is minor. **b. Need to manage risk of keeping material information within company to comply with insider trading rules** - Proper consideration should be paid to preventing insider trading when estimates exist within a firm because calculation of new forecasts,in case that there is a certain level difference from previous year's results,constitutes material circumstance according to Financial Instruments and Exchange Act. Companies must put in place adequate structures to manage information and ensure fair disclosure. **c. Need to manage risk of selective disclosure** - Existence within company of information constituting earnings forecasts for next fiscal period increases risk of selectively disclosing that information, whether deliberately or not, in daily communication with business partners, institutional investors, securities analysts, or the media[3, 4] **d. Significance of voluntary disclosure of information corresponding to earnings forecasts for next period** - Practice to date when company holds information constituting earnings forecasts for next period has been to disclose that information at start of period or once calculations made, reducing risks of (b) and (c) through timely updates
4. Need to disclose revisions to disclosed future estimates during period	Even for future estimates other than those presented as earnings forecasts for next period, any new estimates made during period for items already disclosed could be required to be disclosed in timely manner
5. Recommend explanation regarding categorization of future estimates	When disclosing future estimates, companies encouraged to also explain categorization of estimates in order to encourage investors to use estimates appropriately. - Essentially, estimates do not constitute commitment by management to achieve estimated performance and revision in line with progress should be expected as a matter of course. This applies to broad range of information, not just quintessential earnings forecasts. - Following explanations recommended: ▪ Important background information and assumptions underlying estimates ▪ Company's categorization of information (objective forecast, target, conservative commitments anticipated, but information need not be limited to these categories) should be adequately explained through inclusion of proper headlines and classification and attachment of adequate cautionary statements to ensure investors properly understand

Source: Tokyo Stock Exchange; compiled by DIR.

Notes: 1) If it fits the material impact requirements of Rule 407.1 of the TSE Securities Listing Regulations

2) According to Rule 405.1 of the TSE Securities Listing Regulations

3) Etsuro Kuronuma noted in November 2011 article in *Accounting* that selective disclosure violates a company's obligations when it involves the company voluntarily disclosing information, intended to reach the market, to only some investors or disclosing incomplete information. The article also pointed out that disclosing information to analysts in the knowledge that the analysts will publish the information, revealing it to only some investors, is likely contrary to general private law disclosure requirements.

4) The concern has been raised that selective disclosure not only is a source of mistrust in the information disclosure stance of an individual listed company, but foments investor distrust in the equity of the securities market as a whole. We think that, with selective disclosure banned in the US and many countries in Europe, if selective disclosure creeps into the Japanese market it would likely be promptly banned through amendments to the Financial Instruments and Exchange Act.

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Until now, the TSE has required reasonable calculation of future estimates and the disclosure of specific explanations relating to the estimates, including assumptions underlying the earnings forecasts (e.g., forex rates, oil prices) and the impact on earnings of changes in the assumed conditions. *Practical Earnings Forecast Disclosure* requires some level of detail regarding revisions or alternative presentation of earnings forecasts for the next period (Item 1. above) to avoid inviting criticism of companies reverting to simple information disclosure. Specifically, companies will be required to engage in proactive communication with investors as noted below.

1. For example, sustained and detailed disclosure of future estimates useful to investors in making investment decisions, such as
   - Changes in capex plans and associated change in depreciation expense
   - Expected business conditions (assumptions) and earnings sensitivity to changes to those assumptions
2. Disclosure of company's overall view on earnings forecasts for the next period and other future estimates

As noted in Item 5. above, *Practical Earnings Forecast Disclosure* encourages companies to explain how they categorize their future estimates, not just regarding changes to or alternative presentation of earnings forecasts for the next period.

As stated in Item 3. in the chart, *Practical Earnings Forecast Disclosure,* by stating the risk of non-disclosure, indirectly requires listed companies to promptly disclose internal information obtained through reasonable calculations even if the company has not disclosed earnings forecasts or other future estimates when publishing *kessan tanshin*. Disclosed items are determined based on listed companies' individual circumstances.

The TSE is proposing the abolishment of a requirement for listed companies to disclose their estimates of 2Q results after the settlement of accounts for the quarter but prior to the official earnings announcements when not disclosing 1H earnings forecasts before that, when differences from results of the same period the previous fiscal year are at least greater than what the material impact requirements of Rule 407.1 of the TSE Securities Listing Regulations suggest. However, once the difference from the previous year's 1H results has been ascertained, if the impact on full-year earnings forecasts is also greater than what the material impact requirements suggest, the difference then needs to be disclosed as a revision to full-year earnings forecasts.

(3) Implementation period

The TSE expects the revised rules to apply from results announcements for the fiscal year ended March 2012. It also considers earlier implementation possible.