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It's Annual Report Time—Helpful Tips for the Preparation of 2015 Form 20-F

It is that time of the year for a large number of non-US companies to prepare their annual reports on Form 20-F. For companies with a calendar year-end, the Form 20-Fs must be filed with the US Securities and Exchange Commission ("SEC") by 30 April 2016.

To help you with the preparation of this year's annual reports, we highlight the following recent developments, trends and topics that, based on SEC comments over the past year, may be important focus areas of the SEC review process in 2016.

New Revenue Recognition Standard

In May 2014, the Financial Accounting Standards Board ("FASB") and the International Accounting Standards Board ("IASB") issued a new principles-based revenue recognition standard, which replaces the existing prescriptive, industry-specific guidance. The new standard is intended to converge the guidance on recognizing revenue in contracts with customers under US generally accepted accounting principles ("GAAP") and IFRS. In a recent speech, Wesley R. Bricker, the SEC's Deputy Chief Accountant, noted that good practice for reporting companies is to ensure that the agenda for the audit committee, executive management and auditor incorporates timely, candid discussions about not only the appropriateness of the design and status of management's detailed plans for implementation of the new standard and impact assessments but also the sufficiency of resources needed to complete the work timely. As companies file their annual reports on Form 20-F, the SEC Staff may be focusing on reviewing more detailed disclosures about the expected effect that the new standard will have on issuers' financial statements. If that impact is still unknown, then in addition to making a statement to that effect, a company should consider advising investors when that assessment is expected to be completed, so as to provide useful information to investors who need time to analyze the relevance to issuers. The SEC Staff Accounting Bulletin providing interpretative guidance on the new standard relevant to companies preparing their Form 20-F is available here.

Trends in 2015 SEC Comment Letters

In 2015, in its review of annual reports on Form 20-F, the SEC Staff focused on the following themes:

Enhanced Potential Litigation Disclosure

A number of the comment letters issued in 2015 requested issuers to disclose, whenever possible, their best estimates of the potential outcome of pending litigation, and to describe the effects the outcome would have on their financial condition. In cases where the estimated results of pending litigations would exceed a company's contingent liability reserves, the SEC Staff required 20-F filers to assess whether the cost beyond the reserves would have a material impact on the company's financial condition, operations and cash flow.

Companies often worry that disclosing what they believe is the potential outcome of a pending litigation matter puts them at a strategic disadvantage in the matter and thus opt not to disclose their estimates of the outcome.

To address these concerns, the SEC Staff has advised that companies aggregate their estimates of several pending matters in order to prevent any prejudicial effect to the company.

Reserves

The SEC Staff is taking a hard look at how oil and gas companies are calculating their reserves, particularly their proved reserves, and how the sustained low price environment for oil and gas affects capital spending and, in turn, proved undeveloped reserves. In particular, the SEC Staff has been focused on management's process for becoming comfortable with the company's reserves—for example, whether a sensitivity analysis was performed and what prices were used for that analysis.

Impairment Charges

The SEC Staff frequently asks 20-F filers to verify their impairment calculations. While mining, oil and gas, oil field services companies and financial institutions were the focus of this comment last year, we expect oil and gas, as well as oil field services companies, to continue to draw additional scrutiny. 20-F filers should describe the methods and key assumptions used for their impairment analysis and should be able to explain their reasons for assigning the values they used for key assumptions. Companies should also note the factors that led them to recognize an impairment charge. When a cash generating unit has been impaired, issuers should identify that unit. Given the depressed commodity price environment, natural resource companies in particular should consider whether they need to perform an impairment test, and if they decide that the test is unnecessary, should be able to explain why they made such determination.

Taxes and Currency Fluctuations

The SEC Staff has placed special emphasis in comment letters on requiring companies to explain the potential tax liability of their overseas operations, in particular given the increased scrutiny by European regulators of the tax liabilities of international companies operating in Europe. 20-F filers should expect to be asked to explain how the different statutory rates in the different countries where they operate affect their effective tax rate and obligations. Moreover, in line with the SEC Staff comments, companies should describe which countries' tax structures present the greatest threat of materially affecting their effective tax rate and how such potential impact could affect the results of their operations. Similarly, the SEC Staff has requested that companies disclose the effects of foreign currency exchange rates by quantifying the effect of changes in the exchange rate on the results of their operations to allow investors to better understand how the business is performing.

Internal Controls

Another point of emphasis is on issuers' internal controls over financial reporting. Whenever issuers find any significant deficiencies or material weaknesses with their internal controls, issuers should report them to the SEC and explain how those problems impacted prior financial statements, how they are being remediated and describe whether those problems could affect the financial reporting of subsidiaries in other countries. The company should also address the nature and severity of the significant deficiencies and material weaknesses with a special focus on control environment, risk assessment and monitoring of components.

Dealings with Sanctioned Countries

As in past years, the Office of Global Security Risk of the SEC's Division of Corporation Finance continues to review annual reports on Form 20-F for information regarding global security risk-related issues—in particular, business activities in or with countries and entities subject to sanctions implemented by the Office of Foreign Assets Control of the US Department of Justice.

While technically not a disclosure obligation, in order to keep investors informed of the potential risk that a company might be doing business with a sanctioned country, the SEC Staff has required companies to describe their past, current and future direct and indirect contacts with sanctioned countries. Specifically, the companies have been asked by the SEC Staff to describe any funds, services or support they have provided or intend to provide, directly or indirectly, into the sanctioned countries. In its comment letters, the SEC Staff has also required issuers to disclose any direct or indirect agreements, arrangements or other contacts that the company has had or intends to have with the governments of those countries or any entities that might be controlled by those governments.

In particular, the comments have instructed 20-F filers to describe the materiality of their contacts with any sanctioned countries and explain whether those contacts constitute a material investment risk. According to the comment letters, the materiality assessment should be provided in quantitative terms—the SEC Staff typically requests estimates of the dollar amounts of the associated revenues, assets and liabilities for a period spanning the last three fiscal years and any subsequent interim period. However, the SEC Staff also expects the materiality assessment to include a qualitative component, requiring disclosure of any information that a reasonable investor would deem important in making an investment decision, including the potential impact on the company's reputation and share value.

For a summary of the recent the Joint Comprehensive Plan of Action and upcoming changes to the Iran sanctions regime, see the section "*Iran Sanctions*" below.

Defining Terms

The SEC Staff is increasingly requesting companies to better explain the terms they use in both the financial statements and the "Operating and Financial Review and Prospects" section of Form 20-F. Companies should not assume that SEC reviewers understand the technical terms used as part of the jargon of their respective industries. Instead, the filers should strive to explain terms in ways that a lay person would understand. While not a substantive and material comment, as a focus area of the SEC, a clear presentation of the technical terms is worth ensuring in the preparation stage.

The SEC Staff has encouraged companies to explain how they arrive at the results of any calculations that are included in their annual reports on Form 20-F. This process entails explaining what variables are included in the calculations, defining terms as necessary and precisely naming financial statement line items (or renaming them to clearly convey what those titles represent). For example, when a company's financial statements included a line item titled "Other, net" in relation to an adjustment to a cost of production computation, the SEC Staff asked the company to disclose the types of costs included in the caption and the rationale for subtracting the items in this category.

Liquidity and Capital Resources

Enhanced disclosure may be warranted where there are trends or uncertainties affecting the registrant's liquidity. Companies should consider providing more comprehensive disclosures about material debt covenants when there is an elevated risk of default or when management has concluded it is reasonably likely that covenants will not be met in the future. The SEC Staff has been particularly focused on short-term liquidity needs and expects to see a discussion of the underlying drivers for material changes in the short term.

Financial Disclosure: Non-GAAP Measures

In December 2015, SEC Chair Mary Jo White and senior SEC Staff participated in the *2015 AICPA National Conference on Current SEC and PCAOB Developments*, providing helpful insights on reporting company compliance relevant to 20-F filers. Chair White addressed, among other topics, the use of non-GAAP measures.

Chair White noted in particular that, while a company's chief financial officer and investor relations team may be quite enamored of non-GAAP measures as useful market communication devices, its finance and legal teams, along with its audit committee, should carefully attend to the use of these measures and consider questions such as (for IFRS filers, these considerations apply equally to non-IFRS measures):

- Why are you using the non-GAAP measure, and how does it provide investors with useful information?
- Are you giving non-GAAP measures no greater prominence than the GAAP measures, as required under the rules?
- Are your explanations of how you are using the non-GAAP measures—and why they are useful for your investors—accurate, complete and drafted without boilerplate?
- Are there appropriate controls over the calculation of non-GAAP measures?

The SEC Deputy Chief Accountant Wesley R. Bricker spoke about the Office of the Chief Accountant's ("OCA") current focus areas. In discussing the OCA's accounting consultation activities, he raised one "troubling" observation: some companies have argued that they should not be required to apply a GAAP standard because the result would be "competitively harmful" or "misleading." Mr. Bricker's view is that a better approach starts with identifying what information is useful to investors (and why) and how that information can be appropriately reported. Mr. Bricker also cautioned against companies placing overreliance on benchmarking accounting policies to peer disclosures and SEC correspondence. Benchmarking may be an element of, but is not a substitute for, management doing the work needed to select, support and document a company's accounting policies.

Conflict Minerals Rule Developments

On 18 August 2015, a divided panel of the US Court of Appeals for the District of Columbia Circuit, in *National Association of Manufacturers v. SEC ("NAM")*, upheld its earlier ruling that requiring companies to describe their products as having "not been found to be 'Democratic Republic of the Congo ("DRC") conflict free'" is unconstitutional, thereby invalidating a part of the SEC's conflict minerals rule. On 9 November 2015, the Court of Appeals rejected petitions for a rehearing, following which the SEC may appeal the ruling to the US Supreme Court.

For SEC reporting companies that file conflict minerals disclosure on Form SD, for the moment, the *status quo* prevails. Following the D.C. Circuit's initial decision in *NAM*, the SEC's Division of Corporation Finance had issued a statement that it expected reporting companies to continue to comply with the provisions of the conflict minerals rule that were upheld by the court. However, no company is required to describe its products as "DRC conflict free," having "not been found to be 'DRC conflict free" or "DRC conflict undeterminable." An independent private sector audit will not be required unless a company voluntarily elects to describe a product as "DRC conflict free" in its Conflict Minerals Report. This has been the status for the last two conflict minerals reporting periods (calendar years 2013 and 2014), and, unless the SEC changes the position it took following

the D.C. Circuit's first decision, companies should expect to continue to prepare their conflict minerals disclosure as they have in the past.

Climate Change—The Peabody Settlement and Exxon Mobil Investigation

In 2007, the New York Attorney General served subpoenas on five companies (Peabody Energy, the world's largest private sector coal producer and four coal-intensive power generating companies), requesting information on investigations those companies had conducted in the past and the conclusions those companies had made at the time regarding the effects of climate change on their businesses. The New York Attorney General sought to determine whether those companies' disclosures to investors about such effects were inadequate. The subpoenas were issued under state law at a time of increasing media and investor interest in climate change disclosure, but before the SEC published its climate change interpretive guidance in 2010. Since then, the SEC guidance has significantly increased climate change reporting by public energy companies in the United States.

In November 2015, Peabody Energy entered into a settlement agreement with the New York Attorney General, which focused on two allegations:

- Statements in Peabody's public disclosures that it could not reasonably predict the future impact of any climate change regulation were inconsistent with the fact that Peabody and its consultants had looked into this issue at some length and had projected material and severe impacts from certain potential regulations.
- The International Energy Agency ("IEA") projections included in Peabody's public disclosures showing the impact of climate change developments on the future of the coal market were "cherry picked." Peabody discussed demand under the IEA's "current policies scenario," which is the high case for coal usage, rather than its "new policies scenario," which assumes the implementation of announced government carbon commitments and policies and which the IEA considers its baseline scenario. The Peabody case also illustrates that the regulators will be able to examine the results of any internal assessments or discussions against public disclosures.

The New York Attorney General recently served a subpoena on Exxon Mobil, which similarly seeks information from as far back as 1977, in order to assess Exxon Mobil's climate change disclosures.

The Peabody settlement and the investigation of Exxon Mobil have recast a spotlight on the sufficiency of climate change disclosure by energy companies. Going forward, we anticipate greater scrutiny of climate change related disclosures. 20-F filers should inform the review and drafting of their disclosure, including risk factors, with an understanding of any investigations the company has conducted into the effects of climate change on the company's business, including on the markets for the company's products. To the extent their disclosure includes projections as to the market or demand for a product, companies should ensure that such disclosure is balanced and reflects a range of conventional scenarios on the impact of climate change regulation.

Iran Sanctions

In July 2015, the Islamic Republic of Iran and the E3/EU+3 (China, France, Germany, the Russian Federation, the United Kingdom and the United States, with the High Representative of the European Union for Foreign Affairs and Security Policy) signed the Joint Comprehensive Plan of Action (the "JCPOA"), which is designed to restrict Iran's nuclear program in exchange for ending economic sanctions against the country.

While a number of so-called “secondary” sanctions set out in the JCPOA were lifted on 16 January 2016, the JCPOA does not remove all US sanctions against Iran. Certain sanctions that are outside of the scope of the JCPOA, such as those relating to terrorism and human rights violations in Iran, are likely to remain in force for many years. The “primary” US sanctions, which are directed primarily at US persons, will continue to apply. Further details relating to the JCPOA as well as a comprehensive analysis of the Iran sanctions regime are available on our dedicated website at Shearman Iran Sanctions as well as our recent memo on this topic.

Even though the JCPOA has lifted certain sanctions, the current reporting company disclosure requirements under the Iran Threat Reduction and Syria Human Rights Act of 2012 (TRA) have not been eliminated. Under the TRA, any foreign private issuer that prepares annual reports on Form 20-F is required to disclose in its annual report certain of its (and its affiliates’) investments and transactions relating to the Iranian petroleum and petrochemical sectors and transactions involving the Government of Iran. The company is required to disclose the nature and extent of the activity, the gross revenues and net profits attributable to the activity, and whether the activity will be continued. In addition, the current requirement under the TRA to file separately with the SEC a notice that the disclosure of that activity has been included in the company’s annual report on Form 20-F will also continue to apply.

Cyber security

In the past few years, the SEC has been increasingly focusing on enhanced disclosure relating to cyber security risks. In 2014, SEC Commissioner Luis Aguilar expressed a view that public companies that are victims of cyber attacks should consider disclosing additional information beyond what is required to help protect customers whose private data could be at risk. In October 2015, the NYSE published a guide for listed companies providing helpful guidance with respect to cyber security risk management and best practice. We believe that the regulatory focus on cyber security related matters, including governance and risk assessment, access rights and controls, data loss prevention, vendor management, training and incident response, will continue going forward.

“Publish What You Pay” Reporting for Resource Extraction Issuers

Section 1504 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”), which was signed into law in 2010, directed the SEC to issue rules requiring resource extraction issuers to report annually on payments made to governments. In August 2012, the SEC adopted a final rule implementing Section 1504 of the Dodd-Frank Act, but in July 2013 the SEC rule was vacated by US federal courts. On 11 December 2015, the SEC issued a new proposed rule to implement Section 1504 of the Dodd-Frank Act.

In the newly proposed rule, the SEC addressed the findings of the court that vacated its prior rule. In addition, the SEC indicated that it is endeavoring to more closely align its reporting regime with developments in extractive industry transparency in the European Union and Canada since its original rulemaking, with a view to enhancing the consistency and comparability of the SEC rules with the disclosure requirements of these key jurisdictions.

Under the new proposed rule, SEC reporting issuers that are engaged in the commercial development (including exploration, extraction, processing, export and the acquisition of a license for any such activity) of oil, natural gas or minerals would be required to file annually on Form SD certain information regarding payments made to governments, including subnational governments and state-owned companies. Information regarding such payments would need to be reported at the level of each project and only payments above $100,000

would be required to be included. The SEC is proposing to recognize the equivalency of other jurisdictions' "publish what you pay" reporting regimes that the SEC determines are substantially similar to its rules—this could ultimately include the European Union and Canada.

The SEC will adopt a final rule implementing Section 1504 of the Dodd-Frank Act after considering comments received on the proposed rule. The SEC expects to adopt a final rule by June 2016. If it meets this timetable, the first government payments report would be for the first fiscal year ended on or after 30 June 2017. Until a new final SEC rule becomes effective, 20-F filers are not subject to "publish what you pay" reporting under Section 1504 of the Dodd-Frank Act and need only comply with any applicable home country reporting requirements.

Statements of Opinion After Omnicare

In March, the US Supreme Court issued its decision in *Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund ("Omnicare")*, which provided further clarity on when statements of opinion can give rise to liability under the federal securities laws. The Court held that an honestly held statement of opinion is not actionable as a misstatement of fact, regardless of whether the opinion could be characterized as "objectively false." However, recognizing a different form of opinion liability, the Court also held that a valid claim may exist if the omission of material facts relating specifically to the basis for the opinion renders the opinion statement misleading.

The lesson from *Omnicare* for 20-F preparers is to carefully review any statements of opinion in the Form 20-F. Where statements of opinion are given, a reporting company should also consider disclosing the basis for the opinion, any adverse information that a reader might consider important in forming his or her own opinion and adequate qualifications, risk factors and forward-looking statement disclosures tailored to the particular subject and risks of the opinion.

SEC Updates

Updated Compliance and Disclosure Interpretations

The Division of Corporation Finance last updated its Compliance and Disclosure Interpretations In October 2015. The Compliance and Disclosure Interpretations are available here.

Updated Financial Reporting Manual

The Division of Corporation Finance last updated its Financial Reporting Manual in August 2015. The Financial Reporting Manual is available here.

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