

BUSINESS LAW TODAY

It's Annual Report Time

By [Lisa Jacobs](#)

It is now time for a large number of non-U.S. 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 U.S. Securities and Exchange Commission (SEC) by May 2, 2017.

To facilitate the preparation of this year's annual reports, 20-F filers should note the following recent developments, trends, and topics that may be important focus areas of the SEC in the 2017 review process.

Trends in SEC Comment Letters in 2016

During the 2016 review process of Form 20-Fs, the SEC focused on the following themes.

Non-GAAP and Non-IFRS Disclosures

Disclosures of non-GAAP and non-IFRS measures continue to be important areas of focus for the SEC, as indicated by its comments not only on Form 20-F filings, but also on other SEC filings, such as quarterly earnings releases furnished on Form 8-K. In May 2016, the SEC updated its Compliance and Disclosure Interpretations (C&DIs) regarding the use of non-GAAP and non-IFRS financial measures and highlighted the following topics covered in comment letters to various Form 20-F filers.

- Equal or Greater Prominence. The SEC has requested, as required by [Regulation](#)

[G and Item 10 of Regulation S-K](#), that a presentation of the most directly comparable GAAP financial measure must be presented “with equal or greater prominence” whenever a non-GAAP measure is disclosed. Accordingly, headings, bullets, and tables must first present the GAAP and then the non-GAAP measures (in that order). In addition, derivative non-GAAP metrics such as “adjusted EBITDA as a percentage of sales” need both reconciliation and a presentation of the comparable GAAP measure in a location of equal or greater prominence; in this case, a presentation of net income as a percentage of sales. Such presentations, to the extent they appear elsewhere in the 20-F, must also follow the same chronological order as presented in the first instance.

- Reasons for Inclusion of Non-GAAP/Non-IFRS Measures. It may not be sufficient to include boilerplate language that management believes the company's non-GAAP or non-IFRS measures provide investors with helpful supplemental information. In several comment letters, the SEC has asked companies to elaborate on the usefulness of each non-GAAP or non-IFRS measure to the specific circumstances of the company, sometimes focusing on particular adjustments.
- Accurate Labeling. Measures such as “EBITDA” or “Free Cash Flow” must be

labeled as “adjusted” if they include adjustments beyond those customarily made for measures with those names. Similarly, “pro forma” could only be used where such financial measures have been prepared in accordance with the SEC's rules for pro forma financial statements in Article 11 of Regulation S-X.

- Proper Adjustments and Reconciliation. In its [updated C&DIs](#), the SEC has identified several adjustments as problematic, taking the position that certain non-GAAP adjustments, while not expressly prohibited, are presumed to be misleading. Those adjustments include, among others: normal, recurring cash operating expenses; acquisition-related expenses; and purchase accounting adjustments. In upcoming 20-F filings, companies can still provide explanations as to why such adjustments are relevant but may now face an uphill battle in retaining such adjustments.

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 transactions in or with countries and entities subject to sanctions implemented by the Office of Foreign Assets Control of the U.S. Department of Justice. In its comment letters (sometimes even referencing 20-F filings as far back as 2011), the

SEC has required 20-F filers to disclose any past, current, and anticipated contacts with sanctioned countries, such as direct or indirect agreements, commercial arrangements, or other contacts with the governments of those countries or any entities that might be controlled by those governments. Given this practice, 20-F filers may want to review their prior filings to prepare themselves for any inquiries in this area.

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 for security holders. The materiality assessment should be provided in both quantitative and qualitative terms. Quantitatively, estimates should be denominated in U.S. dollar amounts of the associated revenues, assets, and liabilities for a period spanning the last three fiscal years and any subsequent interim period. Qualitatively, the disclosure should provide any information that a reasonable investor would deem important in making an investment decision, including the potential impact of the transactions on the company's reputation and share value.

Litigation Disclosure

The SEC has continued to request 20-F filers 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 particular, where there is at least a reasonable possibility that a loss may have been incurred (in excess of the amounts already recognized), the comment letters have requested further information on the nature of the loss contingency. Additionally, the SEC has requested disclosure on a) the amount or range of reasonably possible losses in excess of amounts accrued, b) whether reasonably possible losses cannot be estimated, or c) whether any reasonably possible losses are not material to the company's financial statements.

Where a reasonable estimate cannot be made, the SEC has requested 20-F filers to explain a) the procedures the 20-F filer undertook to develop a range of reasonably

possible losses for disclosure and b) for each material matter, what specific factors are causing the inability to estimate and when the company expects those factors to be alleviated. In light of these instructions, however, the SEC has recognized that uncertainties associated with loss contingencies exist. To address this potential area of concern for companies, the SEC has allowed 20-F filers to disclose pending matters on an aggregated basis.

Impairment Charges

Impairment calculations, including the methodology and assumptions, have continued to be an area of interest for the SEC. In certain instances, the comment letters noted inconsistencies in the impairment assessment between certain impairment calculations compared against other impairment calculations performed throughout the 20-F filing. In other cases, the SEC has requested clarification on why certain segments of the company's business were not subject to impairment pursuant to IAS 36. Where an impairment assessment was made, the comment letters instructed companies to explain which factors (including external factors such as declines in commodity prices in 2015) led companies to recognize an impairment charge.

Disclosure of Government Payments by Resource Extraction Issuers

On June 27, 2016, the SEC adopted a final rule implementing Section 1504 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act). Pursuant to Section 1504 of the Dodd-Frank Act (commonly known as "publish what you pay"), the SEC implemented rules requiring resource extraction issuers to disclose payments made to governments for the commercial development of oil, natural gas, or minerals.

The commercial development of oil, natural gas, or minerals is given broad scope to include stages from exploration to mid-stream activities, but does not extend to the final processing stages of refining and smelting. A wide range of payments, such as taxes, royalties, fees, bonuses, infrastructure payments, and community social responsi-

bility payments, whether made in cash or in-kind, must be reported if paid to any level of government, including majority state-owned enterprises. Under the rule, payments must be disclosed by type and total amount at the project level.

The new rule will take effect for an issuer's first fiscal year ending on or after September 30, 2018, and will require disclosure of government payment information annually in a specialized disclosure report on Form SD no later than 150 days after an issuer's fiscal year-end. For companies with a calendar year-end, the first year of compliance will be the year ending December 31, 2018, and the filing deadline will be May 30, 2019. Reports filed in compliance with the substantially similar Canadian and European Union reporting regimes will be accepted by the SEC for purposes of compliance with the SEC rule.

Risk Factors Relating to "Brexit" and the U.S. Presidential Election

Several 20-F filers began including Brexit-related risk factors, and some (as a result of their filing date) have also disclosed potential risks relating to the results of the U.S. presidential election. Although SEC comment letters have not yet requested 20-F filers to assess any risks related to Brexit or the election, some comments directed at U.S. filers have requested consideration of those factors.

Brexit

A number of Brexit-related risk factors disclosed in 20-F filings have focused on the uncertainty surrounding the United Kingdom vis-à-vis its relation to the European financial and banking markets. Almost all risk factors explain that the withdrawal of the United Kingdom from the European Union will involve lengthy negotiations, and the uncertainty could increase volatility in the markets. Some risk factors also note that the Brexit vote is non-binding and that the United Kingdom has yet to invoke Article 50 of the Lisbon Treaty to trigger the withdrawal (which is currently expected to occur in late March of this year). Examples of Brexit risks identified by 20-F filers in-

clude: the fact that sales are denominated in British pounds the depreciation of which may impair purchasing power of European customers, potentially leading to cancellation of contracts or default on payments; restriction of imports and exports; reduction in movement of skilled professionals between the United Kingdom and the rest of the European Union; and increase in regulatory compliance costs.

U.S. Presidential Election

Results of the U.S. presidential election have led to identification of a few risk factors, namely potential changes to existing trade policies and agreements, proposed reforming of the U.S. Food and Drug Administration, potential repeal of the Patient Protection and Affordable Care Act (Obamacare) as well as perceived changes in U.S. social, political, regulatory, and economic conditions. As the SEC has continued to emphasize the need to tailor risk factors to the particular company's circumstances, 20-F filers may need to carefully consider how potential changes in the U.S. social, political, regulatory, and economic landscape could impact the companies' operations and financial conditions. While the result of the election may not be considered a risk itself, subsequent changes in legislation, trade policy, and economic conditions may be important considerations in drafting risk factors.

Iran Sanctions Update

On January 16, 2016, the Joint Comprehensive Plan of Action (JCPOA), which was signed among 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), was implemented, lifting a number of "secondary" sanctions. However, the "primary" U.S. sanctions, which are directed primarily at U.S. persons, continue to apply, as well as certain sanctions outside the scope of the JCPOA, such as those relating to terrorism and human rights violations in Iran.

Furthermore, the results of the U.S. presidential election suggest that the lifting of "secondary" sanctions might be short-lived. The JCPOA contained a provision allowing any party to unilaterally "snap back" sanctions if it determines that Iran has violated the terms of the agreement. Although there is no public information indicating that to be the case, the JCPOA is only an executive agreement, and President-elect Trump has stated that one of his first tasks will be to withdraw from the JCPOA and reimpose the full panoply of sanctions on Iran. For European and other non-U.S. companies that have cautiously reopened commercial ties with Iran, the election considerably raises the risk that sanctions will be reimposed. Companies in the financial and oil and gas sectors face a choice of pursuing Iranian business and thereby taking the risk of facing secondary sanctions. The Office of Foreign Assets Control (OFAC), however, published [Frequently Asked Questions](#) guidance that should sanctions snap back, the U.S. government would provide a 180-day wind-down period for payments. For further details, please see 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 TRA requires companies to continue 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.

SEC Updates

Updated Compliance and Disclosure Interpretations

The Division of Corporation Finance last updated its Compliance and Disclosure Interpretations in November 2016. The Compliance and Disclosure Interpretations are available [here](#).

Updated Financial Reporting Manual

The Division of Corporation Finance last updated its Financial Reporting Manual in November 2016. The Financial Reporting Manual is available [here](#).

[Lisa Jacobs](#), a partner in the Capital Markets Group of Shearman & Sterling LLP, focuses her practice on corporate representations and public and private securities transactions.