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Preparing Your 20-F Filing

There are a number of areas of disclosure focus that should be top of mind for companies as they begin to draft their annual reports.

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Brian D. Hirshberg

Partner
+1 212 506 2176 | New York
bhirshberg@mayerbrown.com

Christina M. Thomas

Partner
+1 202 263 3344 | Washington DC
+1 212 506 2773 | New York
cmthomas@mayerbrown.com

Agenda

- SEC Staff guidance on COVID-19 disclosures
- Changes to Risk Factor disclosures
- Risk factors that are Staff areas of focus
- Key performance indicators and non-GAAP measures
- Amendments relating to financial statement requirements for acquired businesses
- Disclosures for PRC-based companies

Disclosure in Form 20-F

Consider whether disclosure related to COVID-19 is appropriate or necessary.

- **Areas to consider:**
  - Risk factors
  - Information on the company
  - Operating and financial review and prospects
  - Controls and procedures
  - Financial statements

SEC Staff guidance on COVID-19 disclosures

- The SEC staff has issued guidance related to COVID-19 disclosures in various forms:
  - CF Disclosure Topic No. 9 – March 2020
  - Joint Statement regarding earnings releases – April 2020
  - CF Disclosure Topic No. 9A – June 2020
  - Statements from SEC's Chief Accountant – April and June 2020
  - Comment letters issued to registrants

COVID-19 risk factor disclosures

- At the beginning of the pandemic, many companies addressed their risk factor disclosures by including a generic pandemic-related risk. As time has passed, the expectation is that an issuer will update disclosure to provide specific, tailored risks

Sample SEC comment
We note your disclosure that the extent to which your operations may be impacted by the COVID-19 pandemic will depend largely on future developments, which are highly uncertain and cannot be accurately predicted, including new information that may emerge concerning the severity of the outbreak and actions by government authorities to contain the outbreak or treat its impact. Please amend your risk-factor disclosure to provide more detailed risks related to the COVID-19 pandemic, tailored to your specific facts and circumstances. For guidance, see CF Disclosure Guidance: Topic No. 9 (25 March 2020)

- Review existing risk factors, and consider whether these should be revised to address events that already have come to pass, and to address new risks that have been identified as the pandemic has become more prolonged and its effects more wide-reaching
- Consider the impact of COVID-19 as it relates to all risks

Forward-looking disclosure

- Chairman Clayton and Director Hinman's joint statement urged companies to provide as much information as is practicable regarding their current financial and operational status, as well as their future operational and financial planning
- "We…recognize that companies often are cautioned to limit their forward-looking disclosures, and particularly specific estimates, to those required by our rules to limit legal risk in the event the forward-looking estimates prove to be incorrect. In this regard, we encourage companies to avail themselves of the safe-harbors for forward-looking statements." *See* Section 27A of the Securities Act and Section 21E of the Exchange Act
- Historical information may be relatively less significant
- Would not expect good faith attempts to provide appropriately framed forward-looking statements to be second-guessed by the SEC

Lessons from SEC enforcement actions

- Cheesecake Factory (Dec. 4, 2020) – First enforcement action for misleading investors about the financial effects of the pandemic
  - Statements the company was "operating sustainably" when it was losing $6M per week and had only 16 weeks of cash remaining and had informed its landlords that it would not pay any rent in April, due to impacts of the pandemic
  - Shared its financial distress with potential private equity investors but gave the opposite message to the market
  - SEC: When public companies describe the impact of COVID-19, they must be accurate. Disclosure should be tailored to the firm and industry-specific effects of the pandemic on the business and operations. Issuers who make materially false or misleading statements will be held accountable
    - Echoes the March 23, 2020 Statement from the Co-Directors of the Division of Enforcement

Lessons from SEC enforcement actions

- Decision Diagnostics Corp. (Dec. 18, 2020) – Enforcement action against the company and the CEO following temporary trading suspension in April 2020
  - Making false and misleading claims in press releases regarding the development of a working, break-through COVID-19 rapid blood test when, at the time, they had no physical testing device and their technology was unproven
  - SEC: This is an unprecedented time when the need for truthful disclosures concerning COVID-19 tests is very important. The Commission is identifying potential areas of fraud during the pandemic to hold accountable those who exploit the pandemic to harm investors

Recent SEC amendments to Regulation S-K

- Description of business: New human capital resources disclosure topic
  - The company's human capital resources (e.g., number of employees), and
  - Human capital measures or objectives that the company focuses on in managing its business.
- Human capital management disclosure related to COVID-19
  - "Beyond the income statement and the balance sheet effects, we recognize that COVID-19 may significantly impact operations, including as a result of company efforts to protect worker health and well-being and customer safety. The impact of company actions and policies in this area may be of material interest to investors, and we encourage disclosures that address that interest."

Changes to risk factor disclosures

- Summary required if the Risk Factors section exceeds 15 pages
  - 2 pages or less
  - In the "forepart" of the annual report or prospectus
- Standard changed from "most significant" to "material" risks
- Organize logically under relevant headings
  - Subcaption describing the risk still required
- Generic risk factors are discouraged and, if presented, must be placed at the end under the caption "General Risk Factors"

Risk Factors that are Staff Areas of Focus

Risk Factors

- Form 20-F must include a summary of the risks that make an investment in the FPI's securities speculative.
- This discussion should not present risks that could apply to any issuer or any offering; rather the discussion should focus on the specific risks affecting the FPI or the offered securities.
- Risk factors may include, among other things, the FPI's lack of operating history, lack of profitable operations in recent periods, financial position, business or proposed business, or lack of a liquid market for the offered securities.

Risk Factors *(cont'd)*

- The SEC encourages issuers to present risk factors in the order of their significance to the issuer.
- Each risk factor should be concise and explain clearly how the risk affects the FPI.
- The inclusion of any material misstatements or omissions in the risk factors, whether intentional or not, may subject the FPI and its officers and directors to liability under the U.S. securities laws.
- The staff of the SEC's Division of Corporation Finance has been focused on a number of initiatives related to periodic reports over the last few years.

Cybersecurity Risks

- In October 2011, the SEC issued disclosure guidance on cybersecurity risks.
- The guidance is intended to assist companies in assessing what disclosure should be provided with respect to cybersecurity risks and cyber incidents and how cybersecurity risks and their impact should be described in SEC filings.

Global Security Risks

- The SEC Staff has been increasingly monitoring the disclosure of U.S. and non-U.S. registered companies with respect to their dealings with countries identified as state sponsors of terrorism, including Cuba, Iran, Sudan and Syria.
- The SEC Staff's approach has been intensified as the international community has imposed new and increasingly more stringent sanctions on these countries.
- Other factors to be considered include potential damages to the company's reputation as a result of the publicity of these dealings.

SEC Areas of Focus

- Specific examples include:
  - Disclose material risks relating to the transition away from U.S. dollar LIBOR
  - Disclose material risks associated with Brexit along with anticipated effects on business
  - Does the FPI face a material risk of losing customers, a decrease in sales or revenues or an increase in costs due to tariffs or other factors?
  - Is demand for the FPI's products especially sensitive to exchange rates or changes in tariffs?
  - COVID-19 risk factor disclosure

Key Performance Indicators and Non-GAAP Measures

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Key Performance Indicators

- On January 30, 2020, the SEC provided guidance regarding the disclosure of key performance indicators and metrics used in the MD&A section.
  - Similar to earlier concerns raised by the SEC with respect to the use of non-GAAP financial measures.
- The SEC's Division of Enforcement has taken action in recent years against companies relating to the use of misleading key performance metrics.
- Item 303(a) of Regulation S-K requires discussion of "such other information that the registrant believes to be necessary to an understanding of its financial condition, changes in financial condition and results of operations." In addition, Instruction 1 to Item 303(a) requires discussion of "statistical data that the registrant believes will enhance a reader's understanding of its financial condition, changes in financial condition, and results of operations."

Key Performance Indicators *(cont'd)*

- Guidance reminds each registrant that uses metrics in its MD&A that, under existing requirements, it "need[s] to include such further material information, if any, as may be necessary in order to make the presentation of the metric, in light of the circumstances under which it is presented, not misleading.
- SEC generally expects that a metric be accompanied by the following disclosure:
  - A clear definition of the metric and how it is calculated;
  - A statement indicating the reasons why the metric provides useful information to investors; and
  - A statement indicating how management uses the metric in managing or monitoring the performance of the business.

Key Performance Indicators *(cont'd)*

- If a company changes the calculation method or presentation of a metric from one period to another or otherwise, it should consider disclosing, to the extent material:
  - The differences in the way the metric is calculated or presented compared to prior periods;
  - The reasons for the change;
  - The effects of the change on the amounts or other information being disclosed or previously reported; and
  - Other differences in methodology and results that would reasonably be expected to be relevant to an understanding of the company's performance or prospects.
- Depending on significance, it may be necessary to recast prior metrics to conform to the current presentation following a change in methodology.

COVID-related Non-GAAP Measures

- When you take a defined GAAP measure and either exclude items that are components or include items that aren't components, the result is a non-GAAP financial measure.
- In late March 2020, SEC Staff at the Division of Corporation Finance issued CF Disclosure Guidance: Topic No. 9, *Coronavirus (COVID-19)* ("Topic 9 Guidance"), in which they frowned upon companies giving way to any pandemic-driven pressure to "present … non-GAAP financial measures or metrics for the sole purpose of presenting a more favorable view of the company."
- Instead, the SEC Staff encouraged companies to share "why management finds the measure or metric useful and how it helps investors assess the impact of COVID-19 on the company's financial position and results of operations."

Amendments to Financial Disclosures about Acquired Businesses

Amendments to financial disclosures about acquired businesses

- On May 21, 2020, the SEC amended financial disclosure rules with respect to business acquisitions required by Rule 3-05 and Article 11 of Regulation S-X
- Aims to improve financial information available to investors about acquired or disposed businesses, facilitate more timely access by issuers to capital, reduce complexity and costs to prepare disclosures
- Effective Date: January 1, 2021
- Amendments revise Rules 3-05 (financial statements of acquired businesses), 3-14 (real estate operations), Article 11 (pro forma financial information), other related rules of Reg S-X

Background

- Rule 3-05 requires audited annual and unaudited interim financial statements to be provided if a significant acquisition has occurred or is probable, and the business acquired or to be acquired would be considered a significant subsidiary under Rule 1-02(w) of Reg. S-X, substituting 20% for the 10% trigger threshold in that rule
- Rule 11-01 of Reg. S-X requires unaudited annual and interim pro forma financial statements if a significant acquisition has occurred or is probable, looking to the same tests in Rule 1-02(w) for determining whether a business acquisition is significant
- Rule 1-02(w) contains three tests for determining whether a subsidiary or business combination is significant – investment test, asset test, income test. Under Old Rule:

Investment Test	Asset Test	Income Test
$\frac{\text{Purchase Price}}{\text{Buyer's Total Assets}}$	$\frac{\text{Target's Total Assets}}{\text{Buyer's Total Assets}}$	$\frac{\text{Target's Pre-Tax Income}}{\text{Buyer's Pre-Tax Income}}$

Revised Investment Test

- Investment Test has been revised:
  - For acquisitions . . . and dispositions this test is met when the registrant's and its other subsidiaries' investments in and advances to the tested subsidiary exceed 10% of the aggregate worldwide market value of the registrant's voting and non-voting common equity, or if the registrant has no such aggregate worldwide market value the total assets of the registrant and its subsidiaries consolidated as of the end of the most recently completed fiscal year
  - When determining the aggregate worldwide market value of the registrant's voting and non-voting common equity, use the average of such aggregate worldwide market value calculated daily for the last five trading days of the registrant's most recently completed month ending prior to the earlier of the registrant's announcement date or agreement date of the acquisition or disposition

Revised Investment Test

- Changes to the Old Rule:
  - Replaces denominator with aggregate worldwide market value of voting and non-voting common equity for total assets when the registrant has a market value for its voting and non-voting common equity
    - If there is no aggregate worldwide market value, then use the denominator in Old Rule
  - Requires inclusion of fair value of any contingent consideration in calculating investments in or advances to the tested subsidiary unless likelihood of payment is remote

Investment Test (Old Rule)	Investment Test (New Rule)
$\dfrac{\text{Purchase Price}}{\text{Buyer's Total Assets}}$	$\dfrac{\text{Purchase Price}}{\text{Buyer's Aggregate Worldwide Market Value of Common Equity}}$

Revised Income Test

Income Test has been revised to add a revenue component.

- The test is met if:
  - The absolute value of the registrant's and its other subsidiaries' equity in the tested subsidiary's consolidated income or loss from continuing operations before income taxes (after intercompany eliminations) attributable to the controlling interests exceeds 10% of the absolute value of such income or loss of the registrant and its subsidiaries consolidated for the most recently completed fiscal year; and
  - The registrant's and its other subsidiaries' proportionate share of the tested subsidiary's consolidated total revenue from continuing operations (after intercompany eliminations) exceeds 10% of such total revenue of the registrant and its subsidiaries consolidated for the most recently completed fiscal year. This component does not apply if either the registrant and its subsidiaries consolidated or the tested subsidiary did not have material revenue in each of the two most recently completed fiscal years

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Revised Income Test

- Changes to the Old Rule:
  - Adds a revenue test that must be satisfied in addition to the income test
  - Both the revenue test and the income test thresholds must be exceeded for the income test to be met
  - The revenue test does not apply if either the registrant or the tested subsidiary did not have material revenue in either of the previous two years
  - Loss years reflected at absolute value rather than a zero

Income Test (Old Rule)	**Income Test (New Rule)**
$\frac{\text{Target's Pre-Tax Income}}{\text{Buyer's Pre-Tax Income}}$	The ***lower*** of: $\frac{\text{Target's Pre-Tax Income}}{\text{Buyer's Pre-Tax Income}}$ **and** $\frac{\text{Target's Revenue}}{\text{Buyer's Revenue}}$

Audited Financial Statements for Significant Subsidiaries

- Amended Rules require up to two years of Rule 3-05 Financial Statements
  - Previously, three years required if a significance test exceeded 50%
  - Third year eliminated because less likely to be indicative of current condition and results while adding significant incremental cost
- Where a significance test exceeds 20% but none exceeds 40% financial statements are required for the “most recent” interim period specified in Rule 3-01 and 3-02
  - As opposed to “any” interim period
  - Eliminates need for comparative interim period where only one year of audited Rule 3-05 Financial Statements required
- Rule 4-01(a) requires further material information as necessary to make required statements not misleading

Periods for Rule 3-05 Financial Statements

PERIODS TO BE PRESENTED	
Significance Level	**Required Financial Periods**
If all significance tests less than 20%	No Rule 3-05 Financial Statements required
If any significance test greater than 20% but none exceed 40%	One year of audited financial statements; unaudited financial statements for most recent interim period (but no corresponding prior year interim period)
If any significance test greater than 40%	Two years of audited financial statements and unaudited financial statements for most recent, and corresponding prior year, interim period

Pro Forma Information to Measure Significance

- Filed pro forma financial information that only depicts significant business acquisitions and dispositions consummated after the latest fiscal year-end may be used to measure significance, if:
  - Rule 3-05 Financial Statements (or, for real estate operations, Rule 3-14 Financial Statements) have been filed for any such acquired business, and
  - Pro forma financial information required by Article 11 for any such acquired or disposed business has been filed
- Pro forma financial information used to measure significance may only give effect to the subsequently acquired or disposed business
- Pro forma information used to measure significance may not give effect to Autonomous Entity Adjustments, Management's Adjustments, or other transactions, such as the use of proceeds from an offering
- Once a registrant uses pro formas to measure significance, it must continue to use pro formas to measure significance until the next annual report on Form 10-K or Form 20-F

Individually Insignificant Acquisitions

- The Amended Rules clarify that "individually insignificant businesses" include:
  - Any acquisition consummated after the registrant's audited balance sheet date whose significance does not exceed 20%,
  - Any probable acquisition whose significance does not exceed 50%, and
  - Any consummated acquisition whose significance exceeds 20%, but does not exceed 50%, for which financial statements are not yet required because of the 75-day filing period.
- Pre-acquisition historical financial statements only for those businesses whose individual significance exceeds 20%
- Pro forma financial information depicting the aggregate effects of all "individually insignificant businesses" in all material respects
- Exception permitting pro forma financial information not to be provided does not apply where the aggregate impact is significant

Pro Forma Financial Information Adjustments

- Amendments to Article 11 of Reg S-X modify criteria for pro forma adjustments and provide three new categories of permitted adjustments
- Adjustment criteria for pro forma financial information requirements broken out into three categories:
  - "Transaction Accounting Adjustments" which reflect only the application of required accounting to the transaction
  - "Autonomous Entity Adjustments" which reflect the operations and financial position of the registrant as an autonomous entity if it was previously part of another entity, and
  - Optional "Management's Adjustments" depicting synergies and dis-synergies of acquisitions and dispositions for which pro forma effect is being given if, in management's opinion, such adjustments enhance understanding of the pro forma effects of the transaction
    - As a condition for presenting Management's Adjustments, certain conditions related to the basis and form of presentation must be met

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Transactional Accounting and Autonomous Entity Adjustments

- Transactional Accounting Adjustments must depict:
  - In the pro forma condensed balance sheet, the accounting for the transaction required by U.S. GAAP or IFRS-IASB, as applicable, and
  - In the pro forma condensed income statements, the effects of those pro forma balance sheet adjustments assuming the adjustments were made as of the beginning of the fiscal year presented
  - If no balance sheet effect, then the Transaction Accounting Adjustments to the pro forma statement of comprehensive income should depict the accounting for the transaction required by U.S. GAAP or IFRS-IASB, as applicable
- Autonomous Entity Adjustments
  - Pro forma per share data must give effect to Autonomous Entity Adjustments
  - Must be presented in a separate column from Transaction Accounting Adjustments

Basis for Management’s Adjustments

- Management’s Adjustments must satisfy the following conditions:
  - There must be a reasonable basis for each such adjustment
  - The adjustments are limited to the effect of such synergies and dis-synergies on the historical financial statements that form the basis for the pro forma statement of comprehensive income as if the synergies and dis-synergies existed as of the beginning of the fiscal year presented
    - If such adjustments reduce expenses, the reduction can’t exceed the amount of the related expense historically incurred during the pro forma period presented
  - The pro forma financial information must reflects all Management’s Adjustments that are, in the opinion of management, necessary to a fair statement of the pro forma financial information presented

Practical Considerations

Financial disclosures *re* acquired businesses

The Amended Rules:

- Ease burdens and costs involved in preparation of financial statements
  - Maximum of two (*instead of three*) years of audited annual financials
  - Corresponding prior year interim period required only at more than 40% significance
  - Increased significance threshold for dispositions from 10% to 20%
  - Permit abbreviated financials for acquisitions of a component of an entity
  - Allow omission of target financials once business included in registrant's post-acquisition financial statements for nine months or one year
  - Eliminated required three years of audited annual financials if real estate operation acquired from a related party

Practical Considerations

Financial disclosures *re* acquired businesses *(cont'd)*

The Amended Rules:

- Assist registrants make more meaningful significance determinations
  - Using aggregate worldwide market value for investment test corrects fair value vs. book value mismatch in investment test under Old Rule
  - Adding revenue component to income test prevents anomalous results, especially for registrants with net loss or low net income
- Introduce new obligations and challenges for registrants
  - Management's Adjustments, while optional, require management to present reasonably estimable synergies and dis-synergies of the acquisition and to have a reasonable basis for each adjustment
    - Requires management to state that pro formas reflect all Management's Adjustments that are, in their opinion, necessary to a fair statement of pro formas
  - Registrants will need to get used to presenting pro formas under Amended Rules, including presentation of "Transaction Accounting Adjustments," "Autonomous Entity Adjustments" and related explanatory notes

Practical Considerations

Financial disclosures *re* acquired businesses *(cont'd)*

A few practical reminders and tips for reporting companies:

- Assess how Amended Rules impact your disclosures
  - Public companies that engage or are considering engaging, in acquisitions or dispositions should involve their accounting departments and counsel
- Pay attention to the SEC's reminder that financial disclosures must be complete and not misleading:
  - *"In adopting these changes, we note that regardless of the number of years presented, if trends depicted in Rule 3-05 Financial Statements are not indicative or are otherwise incomplete, 17 CFR 210.4-01(a) ('Rule 4-01(a)') requires that a registrant provide 'such further material information as is necessary to make the required statements, in light of the circumstances under which they are made, not misleading.'"*
- Remember that Rule 3-13 waiver requests are available and can be utilized by registrants

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Disclosures for PRC-based companies

- CF Disclosure Topic Number 10: Disclosure Considerations for China-Based Issuers
  - Risks specific to China-based Issuers
    - Quality and reliability of audits
    - Limitations of US regulators
    - Variable interest entities (VIEs)
    - Evolving laws and regulations
  - Key differences between U.S. issuers and China-based Issuers
  - Disclosure considerations

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