U.S. Securities and Exchange Commission

Division of Corporation Finance: International Financial Reporting and Disclosure Issues

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Prepared by Accounting Staff Members
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I. Overview of Disclosure Rules Applicable To Foreign Issuers

Over the last five years, the number of foreign companies accessing the U.S. public markets has increased dramatically. In that time, over 800 foreign companies have registered securities with the SEC for the first time. As of December 31, 1999, there were over 1200 foreign companies from over 55 countries filing periodic reports with the Commission.

A foreign company that seeks to list its securities on the New York or American Stock Exchanges or the Nasdaq Stock Market must register its securities with the SEC by filing an Exchange Act registration statement, and must subsequently file annual reports. Form 20-F is the form used by most publicly traded, foreign companies for Exchange Act registration and annual reporting because its requirements are tailored specifically for foreign issuers. Form 20-F requires comprehensive disclosure about the company, including information about its business operations and its financial statements.

The Securities Act requires companies to register each public offering of securities in the U.S. In an initial public offering, a foreign company registers its securities using a Form F-1 registration statement. The registration statement includes the prospectus, which is the principal document used to market securities to investors. The disclosure contained in a prospectus generally is the same as that required by Form 20-F and also includes various matters that are specific to the offering.

The integrated disclosure system designed for foreign private issuers provides a number of accommodations to practices in other jurisdictions. These accommodations include:

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- interim reporting on the basis of home country and stock exchange practice rather than quarterly reports;
- exemption from the proxy rules and the insider reporting and short swing profit recovery provisions of Section 16;
- aggregate executive compensation disclosure rather than individual disclosure, if so permitted in an issuer's home country;
- acceptance of three International Accounting Standards relating to cash flow statements (IAS # 7), business combinations (IAS # 22) and operations in hyperinflationary economies (IAS # 21);
- offering document financial statements updated principally on a semi-annual, rather than a quarterly basis; and
- foreign companies may prepare their financial statements using a comprehensive body of generally accepted accounting principles (GAAP) other than U.S. GAAP. Foreign companies that present their financial information in accordance with the GAAP of their home country or International Accounting Standards must include a reconciliation of significant variations from U.S. GAAP.

Instructions for financial statements and the reconciliation to US GAAP are included in Item 17 and Item 18 of Form 20-F.

The Division of Corporation Finance has a separate office -- the Office of International Corporate Finance (OICF) -- that serves as the central point of contact for foreign private issuers registering with the SEC. Senior attorneys in the Office are able to help guide foreign registrants through the registration process. OICF may be contacted at (202) 942-2990.

II. Recent Commission Actions and Other Topical Information

A. Adoption of International Disclosure Rules

On September 28, 1999, the Commission adopted changes to its non-financial statement disclosure requirements for foreign private issuers, to conform those requirements more closely to the International Disclosure Standards endorsed by IOSCO in September 1998 (Securities Act Release No. 7745). The changes are intended to harmonize disclosure requirements on fundamental topics among the securities regulations of various jurisdictions.

The rule changes incorporate the international disclosure standards into Form 20-F. While the IOSCO standards were specifically developed for equity offerings, the Commission has extended their applicability to other registered offerings, listings, and annual reports. The rule changes are effective for registration statements filed after September 30, 2000 and annual reports filed with respect to fiscal years ending on or after September 30, 2000.

The amendments do not change the financial statement reconciliation requirements for foreign issuers, and the Commission will continue to

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require disclosure on topics not covered by the International Disclosure Standards, such as disclosures relating to market risk and specialized industries such as banks, insurance companies and resource companies. The Commission also revised the definition of "foreign private issuer," which determines an issuer's eligibility to use certain Commission forms and benefit from certain accommodations under Commission rules, to clarify how issuers should calculate their US ownership for purposes of the definition. The full text of the rule changes can be found on the SEC's web site at: www.sec.gov/rules/final/34-41936.txt.

1. Age of Financial Statements

a) General

Form 20-F includes new Item 8 that specifies the form, content and age of financial statements of the registrant. New Item 8 supercedes Rule 3-19 of Regulation S-X. The US GAAP reconciliation requirements in Items 17 and 18 of Form 20-F have been retained without substantive change. In general, the financial reporting requirements for foreign registrants will not change, except for the age of financial statements in a registration statement.

Item 8.A.4 of Form 20-F reduces the period before audited financial statements of the most recent fiscal year are required in a registration statement from 18 months old (six months after fiscal year end) to 15 months old (three months after fiscal year end). However, an instruction to Item 8 retains the 18 month period for the following types of offerings where the "blackout" period would be disruptive - (a) exercise of outstanding rights granted by the issuer, if the rights are granted pro rata to all existing security holders, (b) dividend or interest reinvestment plans, and (c) conversion or exercise of outstanding convertible securities or warrants.

b) Annual Updating

The new rules require a foreign registrant to update a registration statement with audited *annual* financial statements three months after its fiscal year-end. This updating is required regardless of whether the registration statement includes audited *interim* financial statements for a recent period. A registrant cannot satisfy its obligation to file *annual* statements by filing *interim* statements. The second sentence of new Instruction 1 to Item 8.A.4 of Form 20-F which states "[y]ou may satisfy this requirement by providing audited financial statements covering a period of less than a full year" was unintentional. The staff is currently considering a technical revision to the Instruction to clarify its intent.

c) Initial Public Offerings

Also, Item 8.A.4 requires that audited financial statements in initial public offerings be no more than 12 months old *at the time of filing*. The Item states that this requirement may be satisfied with an audit as of an interim date. This requirement is *in addition to* the requirement that the audited *annual* financial statements be no more than 15 months old *at the time of effectiveness* of a registration statement. However, an instruction clarifies

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that this applies only where the registrant is not public in any jurisdiction. Further, the instruction indicates that the staff will waive the 12-month requirement where it is not applicable in the registrant's other filing jurisdictions and is impracticable or involves undue hardship. As a result, we expect that the vast majority of IPOs will be subject only to the 15-month rule. The only times that we anticipate audited financial statements will be filed under the 12-month rule are when the registrant must comply with the rule in another jurisdiction, or when those audited financial statements are otherwise readily available. If the 12-month audit is waived in a filed registration statement, the representation must be filed as an exhibit per Instruction 2 to Item 8.A.4. The staff will consider a request for waiver of the 12-month audit at the time of filing the initial registration statement or submitting the initial confidential draft when the registrant knows that a waiver will be necessary prior to effectiveness of the registration statement.

d) Interim updating

Item 8.A.5 reduces the updating period for interim financial statements from 10 months after fiscal year end to nine months after fiscal year end. If interim financial statements are required, they must cover a period of at least six months. Item 8.A.5 also requires financial information more current than the required interim period to be included in a registration statement if that information has been made public. Instructions to this item essentially retain the disclosure provisions of old Rule 3-19(f).

e) Delayed and Continuous Offerings

Item 512(a)(4) of Regulation S-K requires a foreign private issuer to file a post-effective amendment to its registration statement to include any financial statements required by Item 8.A of Form 20-F at the start of a delayed offering or throughout a continuous offering under Rule 415. For this purpose, delayed or continuous offerings include exchange offers, merger and acquisition transactions registered on Form F-4, and takedowns from effective shelf registration statements. For these types of offerings, Item 8.A. ordinarily requires the annual audited financial statements to be not more than 15 months old, and the unaudited interim financial statements to be not more than nine months old. Takedowns from existing shelf registration statements and other types of delayed offerings may not be commenced, and continuous offerings must be suspended, during periods when the financial statements are not current under the Item 512 (a)(4) undertaking. This means that the financial statements must remain current throughout the entire time that an exchange offer is outstanding. It also means that the financial statements must remain current in a merger or acquisition transaction until shareholder approval has occurred. However, this provision does not apply to a registration statement for a typical firm commitment underwritten offering priced under Rule 430A or a listing.

f) Annual Report

The revised age of financial statement requirements in Item 8 did not change the due date for filing an annual report on Form 20-F, which continues to be six months after fiscal year end.

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2. Other Issues Associated with the New Form 20-F

a) Selected Financial Data

Under Item 3.A of Form 20-F, selected data for the earliest two years of the five year period may be omitted if the registrant represents that the information cannot be provided without unreasonable effort or expense, and states the reasons for the omission in the filing. If only some of the required data, such as revenues, is available for the two earliest years, that data usually should be provided. The Instruction to Item 3.A requires that the document disclose any omission as well as the reasons supporting the omission. Pre-clearance from the staff is not required if a registrant meets the criteria. As with any disclosure, the explanation of the reasons for omission is subject to staff review.

b) Audit Report Reference to Compliance with US GAAS

Item 8 of Form 20-F requires the annual financial statements to be audited "in accordance with a comprehensive body of auditing standards." An instruction clarifies that in SEC filings the financial statements must be audited in accordance with US generally accepted auditing standards (US GAAS). This instruction changes the staff's practice of accepting audit reports that state the audit was conducted in accordance with local auditing standards that are "substantially similar" or "similar in all material respects" to US GAAS. That practice was originally adopted to accommodate audit report styles in different jurisdictions that differ from the audit report wording specified by US GAAS. The practice was not intended to relieve the auditor of the responsibility to perform all auditing procedures necessary under US GAAS. The staff will continue to accept wording variations in audit reports to comply with local reporting formats. In all other respects, however, in order to avoid ambiguity, the report must say that the audit was performed in accordance with US GAAS. This guidance is intended to apply to all foreign private issuers other than those reporting under the Canadian Multi-Jurisdictional Disclosure System (MJDS).

Except in two limited transitional situations, the audit report should state that the audit was conducted in conformity with US GAAS for all periods presented. The first exception relates to existing registrants that changed auditors in prior periods. Because full compliance would require the former auditor to issue a report different than the report originally filed with the SEC, the staff would not object if the former auditor re-issues its original report that includes the "substantially similar" language. This exception would not apply to initial filings.

The second exception relates to Canadian registrants. Under the special Canadian Multi-Jurisdictional Disclosure System (MJDS) rules, Canadian GAAS audits continue to be acceptable. In the past, Canadian registrants not under MJDS have also been permitted to file Canadian GAAS audit reports that did not assert substantial similarity to US GAAS. Canadian registrants not under MJDS must now comply with the US GAAS audit requirement. The staff strongly encourages Canadian registrants not under MJDS to file audit reports that state the audit was conducted in conformity with US GAAS for all periods presented, but will not insist that they do so for the comparative prior periods. In any event, a Canadian auditor's report should clearly state which GAAS has been followed each period. Also,

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consistent with Article 2 of Regulation S-X, an auditor should not assert compliance with US GAAS for any period unless it is true.

The requirement for US GAAS audits applies to any required financial statements, including those of foreign businesses, foreign investees, and foreign guarantors under Rules 3-05, 3-09 and 3-10 of Regulation S-X.

As stated in the adoptive release, the staff will continue to accept wording variations solely to comply with local reporting formats. For example, the staff views the Canadian "addendum" paragraph that describes substantial doubt about a registrant's ability to continue in business as an acceptable style variation of the US GAAS going concern reporting requirement. Similarly, an audit report issued in the UK may state "the accounts give a true and fair view of the state of affairs of the company and of the profit of the company". The "true and fair view" report in this context is an acceptable style variation of the "fairly presents" language in US GAAS and is not a true and fair override as discussed in Section IV.D.

c) Impact on MJDS

Canadian registrants that use the MJDS are not required to follow revised Form 20-F and are generally not affected by those rule revisions. However, Form F-10 under MJDS requires *any* financial statements included in the registration statement to be reconciled to US GAAP using Item 18 of Form 20-F. A literal application of that requirement would result in MJDS registrants reconciling interim information more currently than any other foreign private issuers. Historically, the staff has not objected if a MJDS registrant reconciled to US GAAP only those periods that would be required if the filing had been made on a regular foreign form. That is, the registrant could apply the age of financial statement requirements in Rule 3-19 of Regulation S-X. However, as of October 1, 2000, Item 8 of revised Form 20-F superceded Rule 3-19. An MJDS registrant may still rely on this age of financial statement accommodation, but it must now follow the more stringent age requirements in new Form 20-F.

d) Consent requirement

Instruction 2 to Item 10 of Form 20-F requires a consent from the independent accountant to be filed with initial registration statements. This requirement applies to both 1933 Act and 1934 Act registration statements.

B. Concept Release about International Accounting Standards

The Commission has been working with the International Accounting Standards Committee (IASC) through the International Organization of Securities Commissions (IOSCO) since 1987 in an effort to develop a set of accounting standards for cross-border offerings and listings. The IASC is an independent, private sector body that was formed in 1973 by the professional accounting bodies in the US and eight other industrialized countries to improve and harmonize accounting standards.

In July 1995, IOSCO and the IASC joined in an announcement that the IASC had developed a work program focusing on a core set of standards previously identified by IOSCO as being the necessary components of a

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reasonably complete set of accounting standards.

In April 1996, the IASC announced that it had accelerated its work program, and the Commission responded with a press release expressing support for the IASC's objective. The Commission's statement noted that the standards should include a core set of accounting pronouncements that constitute a comprehensive, generally accepted basis of accounting; that the standards be of high quality, *i.e.*, they must result in comparability and transparency, and they must provide for full disclosure; and that the standards must be rigorously interpreted and applied.

On February 16, 2000, the Commission issued a concept release on the elements of a high quality financial reporting framework, one of which is high quality accounting standards (Securities Act Release No. 7801). The release solicits comment regarding the quality of the IASC standards and raises questions regarding what supporting infrastructure is necessary in an environment where issuers and auditors often are multinational organizations, providing financial information in many countries. The release seeks to identify what important concerns would be raised by acceptance of IASC standards; and then asks for comment on whether the Commission should modify its current requirement for all financial statements to be reconciled to U.S. GAAP. The release emphasizes a desire to gain knowledge of respondents' first hand experience with IAS. In particular, it asks about experiences that (a) issuers have had with applying IASC standards when preparing financial statements; (b) public accountants have had with auditing the application of the standards; and (c) investors have had with using financial statements prepared using those standards. The deadline for comments was May 23, 2000.

In May 2000, IOSCO completed its assessment of the suitability of 30 core IASC standards (the "IASC 2000 standards") for use in cross-border offerings and listings. IOSCO approved a resolution recommending that its members permit the use of 30 IASC standards, supplemented by reconciliation, disclosure and interpretation as necessary to address outstanding substantive issues at a national or regional level. Supplemental treatments may include reconciliation to show the effects of applying a different accounting method, additional disclosure, and use of a particular interpretation of an IASC standard. At the same time, the IOSCO Technical Committee issued a report that identifies about 120 substantive issues relating to the IASC 2000 standards and outlines one or more supplemental treatments that might be applied to address each issue. The IOSCO resolution is non-binding and implementation is subject to rule-making processes by the individual national members.

C. Issues Related to Other Recently Adopted Rules

1. General

The discussion below highlights implementation issues that foreign registrants may encounter with respect to certain recently adopted rules. Summaries of the principal provisions and effective dates of these rules can be found in the Division's "Current Issues and Rulemaking Projects" and "Current Accounting and Disclosure Issues in the Division of Corporation Finance" on the SEC website.

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2. Audit Committee Disclosures

In December 1999, the Commission adopted new rules to improve public disclosure about the functioning of corporate audit committees and to enhance the reliability and credibility of financial statements of public companies (Exchange Act Release No. 42266). Foreign private issuers currently are exempt from the proxy rules, are not required to file Quarterly Reports on Form 10-Q or 10-QSB, and are subject to different corporate governance regimes in their home countries. Accordingly, the new rules are not applicable to foreign private issuers, including those that elect to file on domestic forms.

3. Auditor Independence

All auditors whose audit reports are required to be included in SEC filings, including auditors of foreign private issuers, acquired foreign businesses, and foreign investees must follow US independence rules. The SEC does not accept compliance with foreign independence rules in lieu of or as a substitute for compliance with the SEC's independence rules and regulations. In November 2000, the Commission voted to adopt new rules that modernize the requirements for auditor independence primarily in three areas:

- Investments by auditors or their family members in audit clients;
- Employment relationships between auditors or their family members and audit clients; and
- The scope of services provided by audit firms to their audit clients.

The new rules are set forth in Rule 2-01 of Regulation S-X (Securities Release No. 7919).

The new rules also require registrants to disclose in their annual proxy statements certain narrative and quantified information about non-audit services provided by their auditors during the most recent fiscal year. Foreign private issuers are not subject to the requirements of the proxy rules. Accordingly, the new disclosure requirements are not applicable to foreign private issuers.

4. Regulation M-A -- Mergers and Acquisitions

In October 1999, the Commission adopted a new regulatory scheme for business combination transactions (Securities Act Release 7760). The new rules are intended to:

- reduce restrictions on communications about pending business combination transactions;
- balance the regulatory treatment of cash and stock tender offers; and
- update, simplify and harmonize the disclosure requirements.

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The rules include revisions to Forms F-4, S-4 and the tender offer schedules to harmonize the financial statements requirements for the various forms and structures of business combination transactions.

Forms F-4 and S-4 permit foreign target companies that present financial statements under home-country GAAP to reconcile to US GAAP using Item 17 of Form 20-F. These Forms also permit a foreign target company that is not subject to Exchange Act reporting requirements to omit the US GAAP reconciliation if the reconciliation is unavailable or not obtainable without unreasonable cost or expense. If the conditions for omission of the numerical reconciliation are met, a narrative description of all material variations in accounting principles, practices, and methods is required.

Registrants should consider all relevant facts and circumstances in determining whether the US GAAP reconciliation is unavailable or not obtainable without unreasonable cost or expense. For example, the staff has objected to the omission of the US GAAP reconciliation in circumstances where the non-reporting target company was a subsidiary (or investee) of a larger reporting company, and considerable reconciling information for the subsidiary would have already been necessary to prepare the parent company's US GAAP reconciliation.

Registrants should note that the accommodation to omit the US GAAP reconciliation for a target company does not extend to the pro forma information required by Form F-4 and S-4. Pro forma information reflecting the effects of the business combination between the registrant and target company must be either presented on a US GAAP basis or reconciled to US GAAP, even if the target company is permitted to omit the US GAAP reconciliation in its separate financial statements.

5. Financial Statements for Subsidiary Issuers and Guarantors

In August 2000, the Commission adopted rules concerning the financial statements and Exchange Act reporting requirements for subsidiary guarantors and issuers of guaranteed securities (Securities Act Release No. 7878). These rules include revisions to Rule 3-10 of Regulation S-X and new Rule 12h-5 under the Exchange Act. The rules supercede Staff Accounting Bulletin 53, and largely codify the staff's practices and interpretive positions under SAB 53.

Revised Rule 3-10 provides guidance for presenting condensed consolidating financial information about subsidiary issuers and guarantors in the notes to the parent company's consolidated financial statements. Where the parent company's consolidated financial statements are prepared on a basis other than US GAAP, Rule 3-10(i)(12) requires the information in each column of the condensed consolidating information to be reconciled to US GAAP to the extent necessary to allow investors to evaluate the sufficiency of the guarantees. The reconciling information may be based on Item 17 of Form 20-F, and need not duplicate information included elsewhere in the reconciliation of the consolidated financial statements. When applying this guidance, registrants should consider all relevant facts and circumstances regarding the nature, magnitude, direction and trend of reconciling items affecting subsidiary issuers and guarantors, and the extent to which those items are fully communicated in the reconciliation of the parent company's consolidated reconciliation.

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The Release addresses the application of Rule 3-10 and Rule 12h-5 to the Exchange Act reporting requirements for parent companies that are foreign private issuers. The Release clarifies that a parent company that files annual reports on Form 20-F is not required to provide quarterly condensed consolidating information about its subsidiary issuers and guarantors, even if those subsidiaries are incorporated in the US.

In a registration statement under the Securities Act, however, a parent company that is a foreign private issuer is required to include condensed consolidating information about its subsidiary issuers and guarantors for all required annual and interim periods. The periods to be presented are determined by reference to Item 8.A of Form 20-F.

III. Staff Processing and Review of Filings

A. Matters of Interest to Initial Filers

1. Pre-Filing Issues and Confidential Reviews

As foreign issuers plan to list or offer securities in the United States, management may identify many procedural or substantive compliance questions. Issuers are encouraged to contact the staff of the Commission to discuss these questions when they arise. The Commission staff also has implemented procedures to review foreign issuers' initial disclosure documents in draft form, if requested by the issuer. Companies are encouraged to contact Paul Dudek, Chief of the Office of International Corporate Finance (202 942-2990), early in their planning process to answer questions, arrange meetings, or discuss the timing of a confidential review.

Questions about the required financial statements or unusual accounting and financial reporting issues may be directed to Craig Olinger, Deputy Chief Accountant in the Division of Corporation Finance (202 942-2960). On difficult questions, the Division's staff will usually consult with the Commission's Office of the Chief Accountant.

While the staff will respond to inquiries about form requirements or procedures informally, more complex or sensitive disclosure and accounting issues are usually best submitted to the staff on a pre-filing basis in writing. The inquiry should identify clearly the company, its country of incorporation and the issue on which staff guidance or relief is requested. Because the form, content and periods of financial information required in an SEC filing may vary depending on the security or transaction being registered, the request should also describe the company's capital structure and listing or offering plans. The request should also identify the comprehensive basis of accounting and reporting currency to be used in the company's financial statements, as well as the number of periods being reconciled to US GAAP. The extent of information provided about the company's business will depend on the nature of the issue, but should be sufficient to permit the staff to make an informed analysis of the question. The request should explain clearly the basis for the company's conclusion or need for relief. The request should indicate whether the company's auditor has been consulted about the matter, and whether it concurs with the company's conclusion.

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The Office of the Chief Accountant has published a Protocol for Submissions to the Office of the Chief Accountant that outlines the information issuers should include in pre-filing requests about accounting matters. This guidance can be found on the Commission's website at www.sec.gov/offices/account/acproreg.htm.

2. US GAAP Reconciliation in an Initial Registration Statement

A first-time registrant must reconcile its home-country GAAP financial statements for only the two most recently completed fiscal years plus interim periods, rather than all three of the years for which complete financial statements must be included. The transition reconciliation requirements do not affect the basic financial statements that are required. Statements of cash or funds flow and shareholders' equity are required for all periods for which an income statement is presented in the primary financial statements.

3. Foreign Issuers that Use US GAAP for their Primary Financial Statements

A foreign private issuer that presents US GAAP financial statements as its primary financial statements in its initial registration statement may include those audited income statements and cash flow statements for two years, without furnishing complete audited financial for the earlier of the three years. In this case, the registrant may present the 5 years of selected financial data required in the registration statement on the basis of its home-country GAAP, rather than 5 years of US GAAP selected financial data.

4. Pension Accounting under US GAAP in an Initial Registration Statement

Some foreign registrants have concluded that it is not feasible to obtain the actuarial information necessary to implement FASB Statement 87 as of the effective date specified in the standard, which was January 1, 1989 for foreign plans with a calendar year-end. The staff will not object if a foreign registrant that cannot implement FAS 87 as of that effective date due to the unavailability of actuarial data adopts the standard as of a later date. However, the standard must be adopted as of a date no later than the beginning of the first period for which US GAAP reconciled data is required in a Commission filing.

A foreign registrant adopting FAS 87 later than the effective date specified in the standard should allocate a portion of the transition obligation/asset directly to equity on the adoption date based on the ratio of: (a) the years elapsed between the effective date in the standard and the adoption date, to (b) the remaining service period of employees expected to receive benefits as estimated at the adoption date. This process uses the service period at the adoption date as a surrogate for the service period at the effective date specified in FAS 87. Using this method, the transition asset/obligation should be extinguished at the same date as if FAS 87 were adopted on the effective date.

To illustrate the mechanics of this accommodation, assume FAS 87 is

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adopted on January 1, 1998. At that date, the transition obligation is £15,000 and the remaining service period is 15 years. Nine years have elapsed since the effective date of FAS 87. Accordingly, 9/15ths, or £9,000 of the transition obligation would be recorded as a direct reduction of equity in the opening balance sheet under US GAAP. The remaining £6,000 would be amortized as part of pension expense over the next 6 years.

Foreign registrants implementing this accommodation should include the following disclosures:

- the date FAS 87 was adopted for purposes of the financial statements;
- a statement that it was not feasible to apply FAS 87 on the effective date specified in the standard; and
- the amortization period for the transition obligation/asset, and the amount that was recorded directly to equity in the opening balance sheet under US GAAP.

The disclosure of this information is necessary for financial statements prepared under either Item 17 or Item 18 of Form 20-F, and should be furnished whenever an income statement for the period in which FAS 87 was adopted is included in the filing.

B. Draft Submissions

1. Staff Willingness to Review Draft Submissions

The SEC's review of filings by public companies is generally transparent to the public and usually involves the public filing of amendments to remedy disclosure deficiencies identified by staff reviewers. The SEC staff recognizes that a foreign registrant often has special concerns about that transparency. This is particularly true when a foreign registrant's securities trade publicly in its home market, and the company will be making new and different disclosure as a result of its registration with the SEC. To address these concerns, the SEC staff often reviews and screens draft submissions of foreign registrants on a non-public basis. The staff, however, is revising its practice in this area. The staff generally will continue to accept draft submissions in connection with an issuer's initial registration with the SEC. Except in unusual circumstances, however, once a foreign issuer has registered a transaction under the Securities Act or a class of securities under the Exchange Act, the staff will no longer accept from that issuer additional draft submissions and will not review or screen a registration statement until it is publicly filed. The timing and scope of staff review of these draft registration statements is generally the same as for publicly filed registration statements. Foreign companies are encouraged to contact the Office of International Corporate Finance (202 942-2990) to discuss the availability of any relief or accommodation early in the planning stages of a transaction or listing.

2. Completeness of Draft Submission

The time period required for the staff to review, comment on, and

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ultimately declare effective a registration statement depends upon the completeness of the draft registration statement and degree of compliance with the disclosure requirements. Draft registration statements must be complete in all material respects at the time of first submission, unless special arrangements have been agreed in advance with the Office of International Corporation Finance. Common examples of incompleteness include missing or partial US GAAP reconciliations, missing or partial US GAAP disclosure under Item 18, missing annual or interim periods, missing Industry Guide data, and missing financial statements of acquirees and investees. The staff will defer the review of an incomplete or deficient draft registration statement.

3. Audit Reports in Draft Submissions

The staff will expect the auditor's report to be signed and dated at the time the draft registration statement is first submitted, unless special arrangements have been agreed in advance with the Office of International Corporation Finance.

4. Quality of Reconciliation to US GAAP

Accounting firms that routinely audit financial statements that are prepared in accordance with US GAAP and filed with the Commission can be expected to be most knowledgeable about current US accounting practices and interpretations. Because of the importance of the reconciliation to US GAAP in filings with the Commission, registrants and their accountants should assure that appropriate competence is brought to that disclosure before materials are filed or submitted.

Most accountants that practice before the Commission are members of the SEC Practice Section (SECPS) of the American Institute of Certified Public Accountants. Membership in the SECPS and participation in its Peer Review program are a voluntary part of the self-regulatory activities of the AICPA and the Public Oversight Board that are intended to ensure good quality practice before the Securities and Exchange Commission. The SECPS recently modified its rules to address member firms with foreign associated firms that audit SEC registrants. Under the new rules, which became effective January 1, 2000, SECPS members must seek the adoption of policies and procedures by the international organization or the individual foreign associated firms that are consistent with SECPS objectives for audits of SEC registrants. The SECPS member will report to the AICPA the name and country of any foreign associated firms that demonstrates compliance with that objective. The foreign associated firm would be subject to scrutiny as part of the peer review process for the SECPS member firm. The new rules also establish minimum requirements for the review of SEC filings and confidential submissions by a designated "filing reviewer" within the US firm or international organization knowledgeable about US GAAP, US GAAS, US auditor independence and SEC reporting requirements.

The filing reviewer requirement in the SECPS rules is modeled on policies and procedures already in place at many firms. To complement those procedures, the staff has adopted certain practices upon receipt of draft submissions from foreign registrants audited by foreign associated firms. Prior to commencing review, the staff requests written confirmation that

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the SECPS member firm's review procedures were applied to the submission. We also request the name of the designated filing reviewer that the staff may contact with any questions concerning the application of those policies and procedures to the draft submission. The staff's procedure is not intended to specify or alter the nature or scope of a firm's policies or procedures, nor to specify or alter how a firm selects its filing reviewers. The purpose of the procedure is to ensure that foreign associated firms appropriately involve their designated filing reviewer prior to submission of draft registration statements. The staff will consider deferring the review of a draft submission where the application of the firm's policies and procedures to that submission cannot be confirmed.

SEC rules do not require an auditor to be a member of the SECPS. A foreign auditor that is not a member or affiliate of a SECPS member firm may practice before the SEC, provided that the auditor meets all requirements of Article 2 of Regulation S-X and demonstrates sufficient knowledge and experience in applying US GAAP, US GAAS, SEC financial reporting rules, and SEC independence requirements. The Office of the Chief Accountant may request supplemental information from a foreign auditor to ascertain that the foreign auditor has the necessary knowledge and experience.

IV. Audit Reports and Independent Auditors

A. Audit Opinion Qualifications

The staff has received several requests to accept audit report qualifications in circumstances where a foreign registrant has deviated from home-country GAAP or IAS to facilitate a position taken for tax purposes, to produce an accounting effect similar to that of a particular accounting principle generally accepted in a different country, or for other purposes. Home-country law or regulation did not require these deviations, although the home-country securities or industry regulator may have approved them at the registrant's request. The deviations might have continuing effects on reported results of future periods, and might be applicable to similar transactions occurring in future periods.

Financial statements that require a qualification in the accompanying audit report as to compliance with the applicable body of accounting standards do not satisfy the requirements for filings with the Commission. This is true whether the primary basis of accounting is US GAAP, local country GAAP, or IAS. Adjustment of the deviation as part of the reconciliation to US GAAP would not cure the deficiency.

B. Reference to the US GAAP Reconciliation

The reconciliation provided pursuant to Item 17 or 18 of Form 20-F must be included in notes to the financial statements and, accordingly, must be considered by the auditor when expressing an opinion of the financial statements taken as a whole. The auditor's report is required to comply with Rule 2-02 of Regulation S-X, and need not refer specifically to the note containing the reconciliation. However, if the reconciliation furnished in the notes to the financial statements fails to include disclosure of all material departures from US GAAP or the quantification of the effects of accounting differences is materially misstated, the financial statements would be presumed to be materially misleading and an exception should be cited in

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the auditor's report. Similarly, the restatement of a previously filed US GAAP reconciliation to correct errors should be referenced in the auditor's report.

C. Changes in Accounting Principles

If the primary financial statements are prepared in accordance with home-country GAAP and reconciled to US GAAP, the auditor's report does not need to refer to a change in *United States* accounting principles. In this situation, however, the staff would expect the following items to be disclosed:

- The reconciliation to US GAAP should indicate prominently the change in accounting principle along with all of the disclosures regarding the change in a manner consistent with the requirements of the applicable US standard, including disclosure of the justification for the change, and clear explanation of why it is preferable per paragraph 17 of APB 20.
- Selected financial data that includes US GAAP information should be footnoted to advise readers of the change in accounting principle.
- The reference to the US GAAP reconciliation provided in the MD&A should discuss the change in accounting principle.

Pursuant to Article 2 of Regulation S-X, a change in the accounting principles used to prepare the primary financial statements should be disclosed in the auditor's report. Disclosure in a separate addendum to the report in the style suggested by Canadian standard setters for US- Canada Reporting Conflicts is acceptable.

Form 20-F does not have a requirement for a preferability letter. Therefore no preferability letter is required for a change in home country *or* US GAAP accounting principles.

D. True and Fair Overrides

Legislation in certain foreign jurisdictions requires the financial statements to give a "true and fair view" of the state of affairs (balance sheet) of the company and its profit or loss. Such provisions may require the departure from a specific accounting standard (override) to the extent necessary to give a true and fair view.

In some cases, an override is necessary to address a conflict between the particular requirements of UK GAAP and the UK Companies Act. For example, Financial Reporting Standard 6 requires certain "group reconstruction" transactions (similar to reorganizations of entities under common control in the US GAAP literature) to be recognized at historical cost. But under the Companies Act, all business combination transactions must be characterized as either acquisitions (purchases) or mergers (pooling of interests). Since a group reconstruction ordinarily will not meet the conditions for merger accounting, an override of the Companies Act is necessary to comply with UK GAAP. The staff may inquire about such a matter to ensure that it is adequately explained to US investors, but would

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not object to this type of override.

In other situations, registrants have overridden specific requirements of home-country GAAP or IAS in the absence of any legal conflict. Generally, the accounting treatments adopted in lieu of the prescribed treatment have been highly unusual. In some cases, the registrant's adopted treatment appeared to be unique, and not identifiable as an accepted accounting practice in any system of GAAP. In some cases, the prescribed treatment would be consistent with US GAAP, and a reconciliation to the prescribed treatment is furnished. In each case, the staff will challenge the basis on which such an override has been used and the basis on which the auditors have given an unqualified report.

Both UK GAAP and IAS have specific disclosure requirements that include identification of the required treatment from which the enterprise has departed, the nature of the departure, including the treatment that would be required, the reason why that treatment would not give a true and fair view, the treatment adopted and the financial impact of the departure on the enterprise's financial statements. Certain additional disclosures are required under IAS. In the rare circumstances where an override can be justified by the registrant's circumstances and home country practices, the staff will expect full compliance with the disclosure requirements. The disclosure should discuss why an override is necessary, clearly describe the adopted treatment, explain how and when it is applied, disclose the key assumptions or estimates inherent in the method, and quantify its effects on the financial statements.

E. References to Another Auditor

Whenever the principal auditor refers to the work of another auditor, the report of the other auditor must be included in the filing. In some cases, the report issued by the other auditor may refer to financial statements that have been prepared using different accounting standards. For example, the consolidated financial statements may be prepared in accordance with US GAAP, but the other auditor's report on a subsidiary refers to financial statements prepared in accordance with UK GAAP. The staff expects the division of responsibility among the auditors to be clear. One of the auditor's reports should clearly state who is responsible for auditing the "conversion" of the financial statements from the foreign GAAP into the GAAP used in the primary financial statements.

F. Auditor Independence

The SEC does not accept compliance with foreign independence rules in lieu of or as a substitute for compliance with the SEC's independence rules and regulations.

1. Indemnification of Auditors

Indemnification of parties subject to liability under the US securities laws is considered to be contrary to public policy. Indemnification also may impair an auditor's independence, as outlined in Section 602.02.i.i of the SEC's Financial Reporting Codification. The staff generally has not objected to an issuer's indemnification of a *former* auditor for costs incurred in successful

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defense of claims, provided that the current auditor has opined on at least the most recent fiscal year and the indemnification arrangement is fully disclosed. However, the *current* auditor may not be indemnified in any circumstance.

The Companies Act of 1985 permits companies in the United Kingdom to indemnify their *current* auditor for costs incurred in successful defense of claims. This provision may be contained in the company's articles of incorporation, in a contract, or otherwise. In circumstances where an issuer has adopted this provision of the Act, the staff has required the issuer and its auditors to confirm that no actual indemnification has been provided or sought, to acknowledge that such indemnifications are deemed to be unenforceable under US securities laws, and to undertake not to provide or seek indemnification in the future.

2. Fairness Opinions Issued by Auditors

If an auditor renders an opinion on the value of a company, the adequacy of consideration, or the fairness of a transaction that the auditor subsequently will audit (fairness opinion), the staff considers the auditor's independence to be impaired.

Statutes or regulations in various countries (particularly in Europe) require companies to obtain a report from a chartered accountant regarding the consideration to be exchanged in stock-for-stock mergers or other non-monetary exchange transactions. Generally, the accountant is expected to review the Board of Director's explanations and justifications of the exchange ratio. The accountant prepares a report addressed to the shareholders of the combining companies, provides assurance of the objectivity of valuation procedures and results, and indicates agreement or disagreement with the selected exchange ratio. Failure to satisfy all legal obligations assumed as part of the appointment may expose the accountant to liability for damages caused to the companies taking part in the merger, their shareholders and third parties. Similar reports may be required in connection with rights offers or other capital-raising transactions. The staff understands that in many countries, management is permitted to engage any duly licensed accountant to perform these services.

In several recent filings, the registrant's *auditor* performed this service and rendered what appeared to be a fairness opinion. In each case the auditor was unable to confirm that the report did not constitute an opinion on the fairness of the transaction or the adequacy of consideration to shareholders. In these circumstances, the staff considers the auditor's independence to be impaired. Depending upon the particular facts and circumstances, the staff may permit registrants in these circumstances to proceed by engaging another auditor to re-audit the historical financial statements or by terminating the current auditor relationship.

The staff also would consider the auditors' independence impaired where a country *required* the service to be performed by the company's auditor. For example, in Italy the law requires certain opinions about the consideration to be exchanged in certain business combinations, share issuances and non-monetary transactions to be delivered by the company's auditor. The staff would not expect to be in a position to declare effective registration statements that include audit reports where the auditors also have issued

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this type of report. However, representatives of the accounting profession in Italy have developed an alternative form of reporting for use on these types of transactions when the auditor is subject to US independence rules. The staff will view the alternative report as not impairing the auditor's independence, provided that the auditor represents in writing (and discloses in the filing, where applicable) that the report is not an opinion on the value of the company, the adequacy of the consideration to shareholders, or the fairness of the transaction. A related letter written by Lynn Turner dated August 24, 2000 is available at *www.sec.gov/info/accountants/noaction/italyaud.htm*.

Registrants should be aware that Form F-4 requires extensive disclosures about the Board of Director's consideration of a proposed merger or exchange. Where the Board in approving the transaction considers the report of an accountant or other expert, the report and consent of the expert must be included in the registration statement.

If the transaction itself is not the subject of a registration statement, then the representation described above should be furnished to the staff at the time that the next audit report is included in an SEC filing. Once the representation for a particular transaction has been furnished to the staff it need not be re-submitted with respect to subsequent filings.

V. Issues Encountered in Reconciliations to US GAAP

A. Issues Related to Recent US GAAP Pronouncements

1. FASB Statement 133 - Application in Initial Filings

Financial statements filed with the SEC are required to be prepared in accordance with US GAAP, or reconciled to US GAAP if prepared in accordance with another comprehensive basis of accounting, as if the financial statements had always been prepared in accordance with US GAAP. An entity applying US GAAP for the first time must account for derivative instruments and hedging activities in accordance with Statement 133 in all fiscal years beginning after June 15, 2000. Statement 133 provides that, upon its adoption by a company, all hedging relationships must be designated anew and documented pursuant to the provisions of Statement 133. Thereafter, companies may use hedge accounting for those hedging relationships that, at inception of the hedging relationship, were documented and designated as hedges in a manner that would satisfy the requirements of Statement 133.

Therefore, an entity that prepares US GAAP financial statements (or reconciles to US GAAP) for the first time in a period subsequent to the required adoption date of Statement 133 may apply hedge accounting pursuant to Statement 133 if the entity had formally documented its hedging relationships in a manner consistent with Statement 133's requirements. For example, an entity that had previously prepared its financial statements in accordance with IAS, including preparation of documentation of its hedging relationships that satisfies the requirements of Statement 133, could apply Statement 133 hedge accounting when preparing (or reconciling to) US GAAP financial statements for the first time.

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2. FASB Statement 130 - Comprehensive Income

FAS 130 defines the required presentation of comprehensive income as a new basic financial statement, rather than an item of disclosure. Therefore, a statement of comprehensive income or its equivalent is required under both Item 17 and Item 18 of Form 20-F. A foreign registrant may present the statement of comprehensive income in any format permitted by FAS 130. It may be prepared using either US GAAP or home-country GAAP amounts. In the later case, reconciliation to comprehensive income measured on a US GAAP basis is encouraged, but not required.

Paragraph 26 of FAS 130 requires presentation of the components of the accumulated balance of other comprehensive income items on the face of the financial statements or in footnotes. This disclosure is not required under Item 17.

In certain countries, equity components under home-country GAAP are included in retained earnings and are not separately tracked. Reconstruction of these amounts may be impracticable. The staff will generally not object if a registrant concludes, and discloses in its filings, that it is not practical to present the components of the accumulated balance of other comprehensive income items specified by paragraph 26 of FAS 130.

A Statement of Total Recognized Gains and Losses prepared under UK GAAP in accordance with FRS 3 is regarded as being consistent with FAS 130. Also, a statement of changes in equity prepared under IAS in accordance with IAS 1 is regarded as consistent with the requirements of FAS 130.

If a registrant recognizes revaluations of assets in conformity with home country GAAP, the statement of other comprehensive income should include such changes.

3. FASB Statement 131 - Segment Reporting

FAS 131 requires reported segment information to conform to the information reported to management even if that information is not US GAAP. A foreign registrant preparing segment information to comply with the disclosure requirements of US GAAP should present the information using whatever basis of accounting is used for internal management reporting, even if that information is on a home-country GAAP basis. However, segment data should be presented in the same reporting currency as the consolidated financial statements, even if a different currency is used for internal management reporting. As required by FAS 131, the measurement basis for this data would be disclosed. For purposes of applying the 10% significance criteria in FAS 131, a foreign registrant should use its internal basis of accounting in determining whether segments are reportable. As required by FAS 131, reported segments must comprise at least 75% of consolidated revenues.

FAS 131 requires a reconciliation of the segment data to the consolidated financial statements. This presentation should be reconciled to the basis of accounting used in the primary financial statements. Reconciling items from

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the internal management-reporting basis should be isolated in a separate column and described. A foreign registrant using home country GAAP is not required to further reconcile the segment amounts to US GAAP.

Segment reporting in some countries is based on products and services rather than the management approach. For example, possible differences between the types of segments that would be reported under IAS 14 and FAS 131 could require certain registrants to present two sets of segment data.

Item 5 of Form 20-F permits the MD&A discussion to be based on the primary financial statements. However, Instruction 2 to Item 5 and Staff Accounting Bulletin 88 require discussion of matters relating to differences between home country GAAP and US GAAP that impact an understanding of the financial statements taken as a whole. If the Statement 131 segment information provides new information as to how management views the business, or indicates material trends or relationships not apparent from the local GAAP segmental disclosures, that information should be discussed within MD&A.

4. FASB Statement 123 - Stock Compensation Disclosures

The applicability of FAS 123 to foreign registrants depends on whether the financial statements are prepared in accordance with Item 17 or Item 18 of Form 20-F. Registrants filing under Item 18 should comply with the disclosure and pro forma measurement principles of FAS 123 in the same manner as a US company. If a foreign registrant elects not to use the fair value method of accounting for stock based compensation in the reconciliation to US GAAP, the pro forma disclosures of net income and earnings per share, along with all of the other disclosures required by FAS 123, should be provided in the annual financial statements. Foreign registrants filing under Item 17 would not be required to provide pro forma net income and earnings per share or any of the other disclosures specified by FAS 123. However, the registrant should disclose the method of accounting that is followed for purposes of complying with US GAAP. Foreign registrants that follow APB Opinion 25 are reminded that recently issued FASB Interpretation 44 provides significant guidance regarding the application of APB 25.

Under both Item 17 and Item 18 registrants must comply with the requirements of FAS 123 in accounting for transactions with non-employees.

5. FASB Statement 109 - Income Taxes

FAS 109 states that deferred tax assets and liabilities should be adjusted for the effects of a change in tax law or rates in the period that includes the enactment date. In the US, enactment date is considered to be the date that the President of the United States signs the legislation and it becomes law.

FAS 109 does not address specifically how to determine the enactment date in jurisdictions outside the US. Simply stated, enactment date is when all steps in the process for legislation to become law have been completed. For

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example, in Australia enactment date would be when Royal Assent is given to the bill, not when a bill is passed by Parliament. This conclusion is equally applicable to foreign subsidiaries of US companies.

In Brazil, the tax law is sometimes significantly altered by provisional measures that remain in force for three months and expire automatically if they are not extended for an additional three-month period. The provisional measures are not enacted by the legislature and should not be used as the enacted rate for the purpose of recognizing the tax effect of temporary differences under FAS 109.

B. Business Combination Accounting

1. Effect of Transactions in an Issuer's own Stock on Pooling of Interests Accounting

Financial institution registrants may have subsidiaries or divisions that trade, make markets in, write derivative contracts on, or otherwise transact in the registrant's own common shares. Under US GAAP, these transactions are usually considered to be treasury share transactions. A registrant contemplating a business combination to be accounted for as a pooling of interests under US GAAP must evaluate whether these transactions violate paragraphs 47d of APB Opinion 16. Tainted shares related to these activities must be aggregated with all other tainted shares in applying the 10% limitation. The staff believes that it would be extremely difficult to demonstrate that these activities represent a systematic pattern of repurchases to be issued for reasons unrelated to the business combination. Similarly, the staff believes it would be extremely difficult to demonstrate that the purchases are required to fulfill contractual obligations pre-dating the two-year period before initiation of the business combination.

These transactions must also be evaluated under the requirements of paragraph 48a of APB 16 and Staff Accounting Bulletin 96. That guidance prohibits agreements or plans to directly or indirectly reacquire shares issued in the business combination. Transactional activity occurring between the dates of initiation and consummation, or after consummation, are considered to be evidence of agreements or plans to reacquire shares issued in the business combination. Planned reacquisitions of shares related to these activities for a period of two years from the date of consummation would be aggregated with all other tainted shares in applying the 10% limitation. Measurement of the number of shares *intended* to be reacquired in these instances is problematic, and the staff would find it difficult to accept an assertion that the number of shares to be reacquired will be limited to an amount that results in an aggregate tainted share amount less than 10%.

2. Date of Consummation under US GAAP

Paragraph 93 of APB Opinion 16 specifies the date that a purchase business combination should be recognized in the financial statements under US GAAP. Ordinarily that is the date assets of the acquired business are received in exchange for consideration from the acquirer. A purchase business combination should not be recognized as of an earlier date unless a written agreement provides that effective control is transferred to the

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acquirer at an earlier date without restrictions except those required to protect the stockholders of the acquired company. The staff interprets this guidance strictly.

Some merger agreements in various countries may include designation of a retroactive effective date, such as the beginning of the fiscal year. In most of these cases, the rare conditions in paragraph 93 of APB Opinion 16 are not met prior to the exchange of consideration, and the business combination should not be recognized for any period before consummation.

APB 16 and FASB Statement 94 require consolidation of a business acquired in a purchase beginning with the date of acquisition. Some registrants have a practice of applying the equity method or cost method to newly acquired businesses for the period from the consummation date through the end of the fiscal year in which the acquisition occurred. US GAAP does not permit that practice.

The staff has also seen situations where a pooling of interests transaction has been reflected in the financial statements before the merger consideration has been exchanged. Because the exchange of shares is one of the fundamental conditions that must be met to qualify for pooling treatment, the consummation of a pooling of interests cannot occur before the date of that exchange.

3. Financial Statement Requirements after a Reverse Acquisition

A number of foreign companies have obtained a listing in the US by merging into a nonoperating US public shell company whose securities are already registered with the Commission. The transaction is typically accounted for as a "reverse recapitalization." Notwithstanding that substantially all of the registrant's operations after the merger will be conducted outside of the US, the registrant is not a foreign private issuer and must comply with the rules applicable to US public companies. Accordingly, the registrant must file a Form 8-K containing financial statements of the foreign company within 75 days of the merger. To facilitate the initial filing of the foreign company's statements, the staff will not object if the financial statements included in the 8-K are prepared in accordance with a foreign GAAP, but reconciled to US GAAP in accordance with Item 18 of Form 20-F. However, the first Form 10-K following the merger, and any registration statement, should include financial statements prepared in accordance with US GAAP for all periods presented, including those periods prior to consummation of the reverse recapitalization. Financial statements in a foreign GAAP reconciled to US GAAP would not be acceptable.

4. Dual Pro Forma Presentations: Purchase and Pooling

Recently several registrants sought to present US GAAP pro forma information on both the basis that a planned acquisition (a) would be accounted for as a purchase and (b) would be accounted for as a pooling of interests.

Article 11 of Regulation S-X requires alternative pro forma presentations in circumstances where the terms of a business combination may result in a

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range of outcomes. For example, the level of shareholder acceptance of an exchange offer may not be known at the time of filing. Pro formas on a pooling basis may be necessary to reflect acceptance of 90 percent or greater, with alternative pro formas on a purchase basis to reflect lower acceptance.

However, alternative pooling and purchase pro forma presentations should not be used as a substitute for the timely identification and resolution of accounting issues related to the business combination. Purchase versus pooling issues ordinarily should be resolved prior to effectiveness. The staff encourages pre-filing consultations on difficult business combination issues.

5. Age of Pro Forma Information in a Cross-border Business Combination

The age of the pro forma financial information included in a registration statement should be based on the age of financial statements requirement applicable to the registrant. If a foreign private issuer files a Form F-4 and the target company is a US domestic registrant, the age of the pro forma information may be determined by reference to Item 8 of Form 20-F. That is, the pro forma information need only be as current as the most recent balance sheet date required for the registrant, which could be as much as 9 months old at the time of effectiveness. By contrast, if a US domestic registrant files a Form S-4 and the target company is a foreign private issuer, the age of the pro forma information must be determined by reference to Rule 3-12 of Regulation S-X. That is, the pro forma information would generally need to be current within 135 days at the time of effectiveness.

Depending on the fiscal year ends of a domestic registrant and a foreign target company, application of the age of financial statement rules may require the foreign target company to include a period in the pro forma information more current than its separate historical financial statements. Article 11 of Regulation S-X permits the ending date of the periods included for the target company to differ from those of the registrant by up to 93 days, and may provide sufficient relief. The staff also will consider combinations of periods that involve overlaps or gaps in the information of the target company of up to 93 days, provided that the resulting annual and interim periods are of the same length required for the registrant, and there are no overlaps or gaps in the registrant's information. However, the staff would not permit a registrant to omit an interim pro forma presentation because of different fiscal periods.

6. Accommodation for Period of Goodwill under UK Accounting Standards

Prior to the adoption of Financial Reporting Standard No. 10, most U.K. issuers that filed with the Commission charged goodwill against shareholders' equity upon acquisition. For purposes of the US GAAP reconciliation, goodwill was capitalized and amortized over its estimated useful life. Under FRS 10, goodwill is required to be capitalized and amortized over its useful life. However, in certain cases, goodwill may have an indefinite life. Depending on the circumstances, the goodwill amortization period in FRS 10 may or may not be the same as that under IAS 22 or US GAAP.

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Form 20-F does not address specifically whether a registrant may use the 20-F accommodation for IAS 22 when primary financial statements are restated to adopt a recently issued accounting standard. Use of the accommodation in some of these circumstances could result in the presentation of reconciled income and equity amounts that differ from those previously reported. However, the instructions to Items 17 and 18 of Form 20-F contemplate use of this accommodation upon voluntary restatement of primary financial statements to adopt provisions of IAS 22 (or standards consistent with IAS 22).

Therefore, the staff will not object if a registrant that prepares its financial statements in conformity with U.K. GAAP, including FRS 10, omits the US GAAP reconciling disclosures specified by Item 17 or Item 18 with respect to the amortization period of goodwill and negative goodwill, provided that all of the following conditions are met:

- The registrant has adopted FRS 10 by retroactive restatement;
- The period of amortization used in the U.K. GAAP financial statements also is in conformity with IAS 22, as amended in 1993;
- The applicable provisions of IAS 22 are applied to all business combinations as outlined in the instructions to Form 20-F; and
- The disclosures set forth in paragraph 28 of APB 20, *Accounting Changes*, are provided to highlight the nature and effects of the retroactive change in U.K. GAAP on previously reported reconciled income amounts.

This guidance applies only to the amortization period of goodwill and should not be applied by analogy to any other situations.

C. Consolidation and Proportional Consolidation

1. Consolidation Policy Disclosures

Companies are required to disclose the accounting principles used in the preparation of their financial statements. That disclosure should include the consolidation principles applied. In some circumstances, the staff has noted instances where majority-owned subsidiaries were not consolidated, yet disclosure of the reasons for non-consolidation was not made. The staff has objected to the use of boilerplate disclosures regarding an enterprise's consolidation policy when majority owned subsidiaries are appropriately excluded from consolidation. The disclosure should allow an investor to clearly understand why the registrant does not control the subsidiary.

The staff also believes that a comparable level of disclosure should be provided when a registrant appropriately consolidates a less-than majority owned subsidiary. The requirement for clear and complete consolidation policy disclosure applies to foreign registrants using home-country GAAP, and applies both under Item 17 and Item 18 of Form 20-F. The staff believes the disclosure in this area is necessary to meet the requirement for an information content that is substantially similar to U.S. GAAP.

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2. Item 17/18 Accommodation for Proportional Consolidation

Issuers that use proportional consolidation under home country GAAP for investments in joint ventures that would be equity method investees under US GAAP may omit reconciling differences related to classification or display, and instead provide summarized footnote disclosure of the amounts proportionately consolidated. Equity investee financial statements would not be required under Rule 3-09 as the joint venture is included in the registrant's consolidated financial statements. The accommodation is available only if the joint venture is an operating entity, the significant financial operating policies of which are, by contractual arrangement, *jointly controlled by all parties having an equity interest in the entity*. The accommodation does not apply to situations in which the "joint venture" would be consolidated under US GAAP.

The staff has recently noted situations where the accommodation was used for investees that were characterized as joint ventures, but not all parties with an equity interest had the right to share in control. For example, a supermajority voting provision permitted several large equity holders to control the investee without the consent of several small equity holders. The staff has objected to use of the accommodation in these circumstances.

3. Proportionate Consolidation in US GAAP Financial Statements

Generally, financial statements of foreign private issuers prepared using a comprehensive basis of accounting but containing a departure from that basis with respect to a material item are not acceptable in Commission filings. However, in limited circumstances the staff has granted requests to present financial statements using US GAAP except that investments in joint ventures are reported using the proportionate consolidation method. This relief is consistent with the accommodation in Form 20-F that permits registrants to not reconcile classification and display differences of proportionately consolidated joint ventures to the equity method.

The staff could be expected to consider favorably a written request for a waiver for that accounting departure from other foreign private issuers subject to the following conditions:

- the joint venture is an operating entity, the significant financial operating policies of which are, by contractual arrangement, jointly controlled by all entities having an equity interest in the entity;
- the auditors' report addresses this departure from US GAAP;
- the disclosures required by Item 17/18(c)(2)(vi) of Form 20-F regarding proportionate consolidation are provided; and
- retained earnings relating to the joint venture are disclosed similar to entities accounted for under the equity method consistent with Rule 4-08(e)(2) of Regulation S-X.

4. Consolidated Businesses that would be under Equity Method in US GAAP

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Foreign registrants with significant subsidiaries that are consolidated under home-country GAAP, but would be accounted for using the equity method under US GAAP, are encouraged to discuss with the staff the information that should be disclosed in the US GAAP reconciliation. At a minimum, the staff would expect disclosure of the following information: 1) condensed information of the equity investee required by Rule 4-08(g) of Regulation S-X, and 2) a sufficiently detailed reconciliation to allow an investor to reconstruct financial statements prepared in accordance with US GAAP and Regulation S-X. Based on the specific facts and circumstances, the staff may require additional disclosure either in the financial statements or MD&A and may require financial statements pursuant to Rule 3-09 of Regulation S-X.

VI. International Accounting Standards

A. Representations as to Compliance with IAS

Under IAS 1 (revised 1997), *Presentation of Financial Statements,* enterprises that comply with IAS must disclose that fact. IAS 1 also indicates that financial statements should not be described as complying with IAS unless they comply with all the requirements of each applicable standard and each applicable interpretation of the Standing Interpretations Committee.

Some registrants have prepared financial statements in accordance with home country GAAP and in footnotes assert that the financial statements "comply, in all material respects, with" or "are consistent with" IAS. In some of these situations, the registrant may have applied only certain IAS or omitted certain information without explaining why the information was excluded. Where the assertion of compliance with IAS cannot be sustained, the staff will require either changes to the financial statements to conform to IAS, or removal of the assertion of compliance with IAS.

B. US GAAP Difference or Departure from IAS?

The staff has noted a number of situations involving reconciling items that appear to be the result of non-compliance with IAS and not the result of a difference between IAS and US GAAP. As such, there should not be a reconciling item. In many of these situations, the registrant asserted that the application of IAS was insignificant or immaterial; yet they were significant enough to be identified as a reconciling item in the US GAAP reconciliation. The US GAAP reconciliation cannot be used in lieu of full compliance with the IASC standards.

C. Business Combinations

1. Accommodation for Method of Accounting under IAS 22

The criteria to determine the method of accounting for a business combination under IAS 22 are different than US GAAP. However, Form 20-F provides that a foreign private issuer that consummates a business combination that qualifies as a uniting of interests under IAS 22, and consistently applies IAS 22 to all business combinations, may use the uniting of interests method to report the transaction in filings with the SEC,

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without reconciling the method of accounting to US GAAP. That is, no reconciliation of the method of accounting is required even though the transaction may be a purchase under US GAAP.

Similarly, a foreign private issuer that consummates a business combination that qualifies as an acquisition under IAS 22 may use the acquisition method to report the transaction in filings with the SEC, without reconciling the method of accounting to US GAAP. That is, no reconciliation of the method of accounting is required even though the transaction may be a pooling under US GAAP.

The accommodation does not extend to certain types of transactions such as promoter transactions, leveraged buyouts, mergers of entities under common control, reverse acquisitions and other transactions that are not addressed by IAS 22. In these instances, an issuer would be required to quantify the differences in applying US GAAP.

The accommodation applies only to the determination of the method of accounting. Once the method is determined, an issuer would be required to quantify all resulting differences in the reconciliation to US GAAP. To illustrate, if a business combination is an acquisition under IAS 22, the issuer would be required to apply the provisions of US GAAP purchasing accounting using US GAAP balances to determine the US GAAP reconciled amounts.

2. Strict Interpretation of "Uniting of Interests" -- SIC-9

Because of the IASC Board's clear intent to restrict uniting of interests accounting to certain limited and rare circumstances, uniting of interests should not be presumed simply because ambiguity may exist about whether one shareholder group dominates the combined entity. An exhaustive search for an acquirer must be performed that considers all the relevant facts and circumstances. The staff believes that in virtually all business combinations an acquirer can be identified.

Standing Interpretations Committee Interpretation 9, issued in July 1998, indicates that all relevant facts and circumstances should be considered in determining the classification of a business combination. This includes an exhaustive search for an acquirer. SIC-9 clarifies that a business combination should be classified as an acquisition unless all the characteristics in IAS 22.15 (revised 1998) exist and it can be demonstrated that an acquirer cannot be identified.

The issuance of SIC-9 provides an important benchmark in establishing a more rigorous application of IAS 22. SIC-9 is effective for business combinations given initial accounting recognition in periods beginning on or after August 1, 1998. For December 31 year-end registrants, it applies to business combinations consummated on or after January 1, 1999.

Recently, several companies seeking to enter the SEC reporting system for the first time have accounted for a previously consummated business combination as a uniting of interests in their IAS financial statements. While not yet public in the US, the companies' shares have long been publicly traded on various major stock exchanges outside the US. In each case, the

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business combination transaction resulted in one of the shareholder groups owning more than 50% but less than 60% of the combined company. Because board and management representation was divided equally, the companies believed that an acquirer could not be identified. These business combinations were consummated before the effective date of SIC-9, and the companies did not consider SIC-9 in applying the requirements of IAS 22.

In each case, the staff was unable to concur that the transaction should have been accounted for as a uniting of interests under IAS 22. If SIC-9 had been effective at the time the business combination was given initial accounting recognition, restatement of the financial statements would have been required to reflect the business combination as an acquisition under IAS 22. However, the staff recognized that practice at the time of the business combination was diverse in the application of IAS 22.

Therefore, the staff did not require restatement of the financial statements to be filed with the Commission. However, the companies were required to reconcile the method of accounting for the business combination to the purchase method of accounting under US GAAP. That is, the staff concluded that it was not appropriate to permit the companies to use the accommodation in Form 20-F to avoid reconciliation.

Registrants that have consummated business combinations *after* the effective date of SIC-9 are expected to strictly comply with the requirements of IAS 22 and SIC-9. The staff also will challenge presentations in the primary financial statements of uniting of interests consummated *before* the effective date of SIC-9 where it appears that IAS 22 has been misapplied egregiously. Egregious misapplication may be indicated, for example, where one of the shareholder groups obtains greater than 60% of the combined voting shares, where terms of the combination or related transactions are designed to provide a relative advantage to any shareholder group, or where terms of the combination or related transactions do not result in the combination of effectively the whole of the combining companies' net assets and operations.

3. Accommodation for Goodwill Amortization Period

Under IAS 22 (revised 1993), goodwill and negative goodwill generally are amortized over a period not exceeding 5 years unless a longer period, not exceeding 20 years, can be justified. Items 17 and 18 of Form 20-F currently provide relief from the reconciliation requirements for the amortization period of goodwill and negative goodwill. The accommodation permits US GAAP reconciling disclosures to be omitted with respect to the amortization period of goodwill and negative goodwill if the period of amortization used in the primary financial statements conforms to the requirements of IAS 22 (revised 1993). Because of differences in the methods for determining and allocating purchase price, the amount of goodwill or negative goodwill under the IAS acquisition method may differ from the amount under the US GAAP purchase method. Accordingly, the amount of goodwill or negative goodwill that is subject to the IAS 22 amortization period in the US GAAP reconciliation is the amount determined under US GAAP. The rule requires consistent application for all business combinations consummated after January 1, 1995. However, for business combinations entered into before this date, issuers have the option of

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retroactively applying IAS 22 in the primary financial statements or reconciling to US GAAP.

The accommodations in Form 20-F do not allow a foreign issuer to reconcile to IAS 22. To illustrate, a foreign issuer that charges off goodwill directly to equity would not be allowed to reinstate it in the reconciliation and amortize it under the provisions of IAS 22. Rather, the amortization period would need to comply with US GAAP.

4. 1998 Revisions to IAS 22

a) Goodwill Lives

IAS 22 (revised 1998) eliminates the 20-year maximum life on goodwill. Under IAS 22 (revised 1998), goodwill is to be amortized over its estimated useful life, which is presumed to be 20 years or less. However, this presumption may be overcome in certain cases. Where the presumption is overcome, an enterprise is required to test goodwill for impairment at least annually and disclose the reasons why the presumption is overcome. These disclosures would include a discussion of the factors that played a significant role in determining the useful life of the goodwill.

In IAS 22 (revised 1998), the IASC Board emphasized that only in rare cases will an enterprise be able to support a goodwill life in excess of 20 years. Registrants should be prepared to justify assertions that the 20-year presumption has been rebutted. The staff is likely to challenge situations where a registrant changes its estimate of the useful life of goodwill to a longer period upon adoption of IAS 22 (revised 1998).

Goodwill lives of 20 years or less would continue to be eligible for the accommodation under Form 20-F. The accommodation in Form 20-F is based on IAS 22 (revised 1993). When this accommodation was originally adopted, the staff did not contemplate situations where the goodwill amortization periods under IAS could be significantly longer than those under US GAAP. In the rare case where a registrant concludes under IAS 22 (revised 1998) that goodwill lives exceed 20 years, the need for a reconciliation adjustment to US GAAP lives will depend on the specific facts and circumstances.

The accommodation applies only to amortization periods for goodwill, and not to other types of capitalized intangible assets. IAS 38 addresses amortization periods for other intangible assets. Consistent with IAS 22 (revised 1998), IAS 38 presumes that useful lives of intangible assets will not exceed 20 years, except in rare circumstances where a specific life in excess of 20 years can be clearly demonstrated.

b) Accounting for Negative Goodwill

IAS 22 (revised 1998) also eliminates the benchmark treatment in the existing standard for accounting for negative goodwill, and requires that negative goodwill be measured as the difference between the acquirer's cost and its interest in the fair value of the identifiable assets acquired and liabilities assumed. It also requires that negative goodwill be recognized in the income statement as follows:

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- To the extent that the negative goodwill relates to expected future losses and expenses that are identified in the acquirer's acquisition plan, negative goodwill should be recognized when those losses and expense occur;
- To the extent the negative goodwill does not relate to expected future losses and expenses, the negative goodwill not exceeding the fair value of the non-monetary assets acquired, should be recognized on systematic basis over its estimated useful life, which is presumed to be 20-years or less; and
- All other amounts are recognized immediately.

An entity recognizing negative goodwill in the income statement on a method other than straight-line amortization, under either version of IAS 22, would be required to reconcile these differences to US GAAP.

c) Impairment of Goodwill

The revisions to IAS 22 also include a new requirement to reverse impairment losses on goodwill under certain conditions. Entities adopting IAS 22 (revised 1998) that reverse any prior goodwill impairments also would be required to reconcile these reversals to US GAAP.

D. Accounting for Associates

Under IAS 28, *Accounting for Investments in Associates*, an entity is presumed to have significant influence if it acquires 20% or more of the voting power of an investee. This presumption may be overcome in exceptional circumstances where it is demonstrated clearly that such influence does not exist.

IAS 28 defines significant influence as "...the *power* to participate in the financial and operating policy decisions of the investee . . ." The phrase "power to participate" contemplates having the capacity or ability to participate in the decision-making process. An investor that holds this power has significant influence, even if it elects not to actively participate.

In some European countries, enterprises have a two-board structure -- a supervisory board and a management board. The responsibilities of the supervisory board in these systems typically include, among other things, the ability to appoint the members of the management board and consent to or approve major corporate decisions. The supervisory board may not make the day-to-day decisions, which generally are the responsibility of the management board. However, the supervisory board has the power to participate in the decision-making process. The staff believes that participation on a supervisory board generally confirms rather than rebuts an investor's ability to influence an associate.

While there are differences in *how* the equity method is applied under IAS versus US GAAP, the staff does not believe there is a difference between IAS and US GAAP in determining *when* the equity method should be applied. IAS 28 and US GAAP list the same factors that are indicative of significant influence. FASB Interpretation No. 35, *Criteria for Applying the*

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Equity Method of Accounting Investments in Common Stock (FIN 35), provides additional guidance on circumstances when application of the equity method may not be appropriate. Although IAS 28 does not include the examples of indications outlined in FIN 35, those indications are implicit in the IAS 28 definition of significant influence.

IAS 28 generally requires a registrant and its associates to use the same accounting policies. If an associate uses accounting policies other than those adopted by the registrant for like transactions and events, the registrant ordinarily makes appropriate conforming adjustments to the associate's financial statements when applying the equity method. Paragraph 20 of IAS 28 provides an exception if it is impracticable to make such adjustments. This exception refers to acceptable differences in accounting policies that may arise within IAS. IAS 28 does not contemplate the use without adjustment of associate financial statements prepared on a basis of accounting other than IAS.

IAS 28 also states that procedures appropriate for the application of the equity method are similar to the consolidation procedures set out in IAS 27. As stated in IAS 27, the financial statements are usually drawn up as of the same date. When the reporting dates are different, statements as of the same date are generally required to be prepared. When it is impracticable to do this, financial statements with different reporting dates may be used provided the difference is no greater than three months.

Therefore, the date of the financial statements used by the investor to capture the associate's net income should ordinarily be the same date as the investor's financial statements. If an associate and an investor have different year-ends, the investor should use financial statements of the associate that have a difference in dates that is no greater than three months. Foreign registrants that propose a difference that is more than three months should consult in advance with the staff.

If a time lag exists between dates of the financial statements of the investor and the associate, that fact must be disclosed. In the absence of disclosure, an investor will be entitled to presume that no lag exists. The staff's view regarding disclosure of a registrant's accounting policy regarding time lags applies equally to registrants that present financial statements under home-country GAAP.

E. IAS 27 - Consolidation

IAS 27, *Consolidated Financial Statements and Accounting for Investments in Subsidiaries* requires consolidation of all subsidiaries. Control is presumed to exist when the parent owns, directly or indirectly, more than one half of the voting power of an enterprise unless, in rare and exceptional circumstances, it can be *clearly* demonstrated that such ownership does not constitute control. Paragraph 13 of IAS 27 outlines the circumstances whereby an enterprise would exclude a subsidiary from consolidation. These exceptions relate to instances where (i) the parent has acquired the subsidiary with the view to sell it in the near future or (ii) there are severe long-term restrictions which significantly impair the subsidiary's ability to transfer funds to the parent.

IAS 27 does not include an exception for subsidiaries that operate in

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different industries from the parent. Excluding subsidiaries from full consolidation is not justified just because those subsidiaries operate in different business activities or industries. IAS 27 also does not permit nonconsolidation as a matter of "industry practice".

IAS 27 does not permit controlled subsidiaries to be proportionately consolidated. Further, majority-owned subsidiaries should not be characterized as joint ventures and accounted for using either the equity method or proportionate consolidation unless they meet the definition of a joint venture in IAS 31.

F. Consolidation Policies - Special Purpose Entities

A registrant may establish special purpose entities (SPEs) to conduct research and development or other activities in the areas in which an enterprise and its affiliates are active. While the SPE may have its own governing body, the original sponsor may have the right of first refusal regarding the purchase of intellectual property rights developed by the SPE.

Companies with arrangements like this must consider the requirements of SIC-12, *Consolidation - Special Purpose Entities* (SIC-12). SIC-12 indicates that an SPE should be consolidated when the substance of the relationship between an enterprise and the SPE indicates that the SPE is controlled by that enterprise. The definition of control in IAS 27 encompasses the concepts of both governance and economic benefits and risks. SIC-12 expands on these concepts as they relate to SPEs by providing several indicators of control. These include the following:

- the activities of the SPE, in substance, are being conducted on behalf of the reporting enterprise according to the reporting enterprise's specific business needs,
- the reporting enterprise, in substance, has the decision-making powers of the SPE or its assets, including certain decision-making powers coming into existence after the formation of the SPE, or by setting up an "autopilot" mechanism as part of the formation of the SPE,
- the reporting enterprise, in substance, has the rights to obtain a majority of the benefits of the SPE's activities, or
- the reporting enterprise, in substance, retains the majority of the residual or ownership risks related to the SPE or its assets.

The staff believes that consolidation of an SPE is required in cases where (1) the SPE provides an enterprise with a service (e.g., research or marketing) that is consistent with the enterprise's ongoing central operations which, without the existence of the SPE, would be provided by the enterprise itself, and (2) the enterprise has the right to the economic benefits of the SPE through, for example, a right of first refusal.

SIC-12, *Consolidation - Special Purpose Entities,* is effective for annual financial periods beginning on or after July 1, 1999, with earlier application encouraged. SIC-12, by reference to paragraph 46 of IAS 8, *Net Profit or*

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Loss for the Period, Fundamental Errors and Changes in Accounting Policies (IAS 8), permits transition by either retroactive application, which is the benchmark treatment, or cumulative adjustment, which is the allowed alternative. Based on circumstances the staff has seen, the staff believes that the benchmark treatment should generally be followed.

In circumstances the staff has seen, there was considerable evidence pointing toward consolidation of SPEs under the pre-existing requirements of IAS 27. However, the staff recognizes that registrants either have or will soon adopt SIC-12. Where the application of IAS 27 was not egregious, the staff has not sought restatement of previously published financial statements, provided that the registrant timely adopts SIC-12 using the benchmark treatment.

The use of the allowed alternative treatment, an accumulated adjustment, will generally not produce financial statements that are consistent between periods and comparable to those of other SEC registrants. In addition, they would lack the appropriate degree of transparency for investors in U.S. capital markets.

Registrants that intend to use the allowed alternative treatment should consult with the staff prior to filing. Substantial disclosure, including extensive U.S. GAAP information, would be necessary as part of any proposal. Registrants that are seeking effectiveness of a registration statement prior to their application of SIC-12 will generally be asked to provide the following additional disclosures in their filing:

- First, a statement that the registrant will adopt SIC-12 with retroactive application for all periods presented in its next annual report;
- Second, SAB 74 disclosures about the upcoming SIC-12 adoption, including quantification for all periods; and
- Third, expanded U.S. GAAP reconciling disclosures to include:
  - A condensed U.S. GAAP balance sheet and income statement, showing measurement and classification differences; and
  - MD&A discussion of the U.S. GAAP amounts to the extent necessary for investors to understand trends.

In some cases SPEs may be established to facilitate transfers or securitizations of financial assets. Under US GAAP, an SPE to which financial assets have been transferred (or sold) often is not consolidated by the transferor. In these situations, even if the transfer of assets was accounted for as a sale under IAS, the application of SIC-12 could require the transferor to consolidate the SPE. Therefore, applying US GAAP in accounting for the sale or transfer of financial assets will not necessarily result in compliance with IAS. In these cases, a registrant would be required to provide a reconciling item in the US GAAP reconciliation.

G. Consolidation of German Special Funds under IAS

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- *Background*

Special Funds are widely used investment vehicles in Germany. Special Funds are used to provide tax benefits because the sponsor of a Special Fund is taxed when the Special Fund makes distributions to the sponsor, rather than when investment income on an underlying portfolio is earned. The staff has been advised that these investment vehicles currently have underlying portfolios valued at 500 billion EUR. While the following discussion is based on a fact pattern for a German investment vehicle, similar investment vehicles in other jurisdictions may exist and are likely to be impacted by the staff's views related to the German investment vehicle.

A sponsor forms the Special Fund, whose structure and operation are specified by German law. A Special Fund may not have more than 10 investors. However, the sponsor may fund and own up to the entire economic interest in the Special Fund. The underlying assets held by the Special Fund consist of marketable debt and equity securities.

The sponsor appoints an investment management company. Under German law, the investment management company has authority over all operating and financial decisions related to the Special Fund, including the acquisition, disposition, and voting of the underlying marketable securities. By law, neither the sponsor nor the owner of the investment management company is permitted to dictate or influence the investment management company's decisions. Once appointed, the investment management company cannot be removed except in extraordinary circumstances, such as insolvency.

The sponsor also appoints a depositary bank, which acts as custodian of the Special Fund's assets. Under German law, the depositary bank is responsible for ensuring that the investment management company complies with applicable laws in its administration of the Special Fund. However, the depositary bank must generally comply with instructions of the investment management company.

In some cases, there may be no unrelated third party other than the depositary bank involved in the structure or operation of the Special Fund. That is, no party outside the sponsor and its consolidated subsidiaries has a substantive ownership interest, financial interest, or decision-making authority with respect to the Special Fund. For example, the sponsor, through a consolidated subsidiary, may fund and own the entire Special Fund, and may also own, control, and consolidate the investment management company.

- *Accounting*

For periods prior to the effective date of SIC-12, we understand that German companies adopting IAS have concluded that neither the sponsor nor the investment management company should consolidate the Special Fund. Instead, the sponsor's investment in the Special Fund has been viewed as an investment under IAS 25, *Accounting for Investments* (IAS 25). We also understand that companies generally view Special Funds as SPEs falling within the scope of SIC-12. They generally believe that paragraph 10(c) of SIC-12 introduces a new criterion that applies to the Special Funds, but was not contemplated by IAS 27.

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The staff has objected to that view in circumstances where majority ownership in and decision making authority over the Special Fund reside in different subsidiaries within the same consolidated group. The staff believes that when there is evidence pointing to the principle of control under IAS 27, registrants should consolidate the entity subject to that control. The staff believes that SIC-12 only clarifies concepts and principles that currently exist within IAS 27.

- *Staff Accommodation*

IAS 25 has multiple alternative treatments. Depending upon how IAS 25 has been applied, there may be significant differences between IAS 25 and consolidation in the measurement and classification of balance sheet and income statement amounts.

If the sponsor's investment in a wholly-owned Special Fund has been carried at market value with unrealized gains and losses recorded in stockholders' equity, the principal difference between IAS 25 and consolidation is that investment income and realized gains and losses on the underlying securities held by the Special Fund are not recognized in the sponsor's income statement. In this circumstance, the staff will generally request the registrant to adopt SIC-12 using the benchmark treatment under IAS 8, which requires retroactive restatement. Registrants considering the use of the allowed alternative treatment should consult with the staff prior to filing. Those seeking effectiveness of a registration statement prior to their first required application of SIC-12 will be requested to provide the additional disclosures outlined above in Section VI. E.

H. IAS 14 - Segment Reporting

IAS 14 is effective for periods beginning on or after July 1, 1998. IAS 14 defines a business segment as a distinguishable component of an enterprise that is engaged in providing an individual product or service (or a group of related products or services) and that is subject to risks and returns that are different from those of other business segments. Similarly, geographical segments are defined as a distinguishable component of an enterprise that is engaged in providing products or services within a particular economic environment and that is subject to risks and returns that are different from those of components operating in other economic environments.

Companies must choose either a business segment or geographic segment approach for their primary segment reporting. The choice is generally governed by the nature and source of an enterprise's risks and returns. This decision affects the required disclosures under IAS 14 because more limited information is required for the secondary segment reporting.

Some have asserted an "impracticability" exception not contained in IAS 14 regarding certain secondary segment disclosures. For example, an enterprise maintains a production facility for different business segments that cut across different geographic segments. Assuming that the primary segment reporting was on a geographic basis, the staff has objected to the general assertion that such an asset could not be allocated to the enterprise's business segments because of impracticability.

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Some have asserted that research and development departments, which carry out these activities for the enterprise as a whole, could be grouped as a separate business segment. These research and development activities did not generate separately identifiable revenues for the consolidated group and therefore did not separately generate returns for the enterprise. Under IAS 14, segment expenses include those costs incurred at the enterprise level on behalf of a segment that relate to the segment's operating activities and can be directly attributed or allocated to the segment on a reasonable basis. The staff believes these research and development activities do not meet the definition of a business segment, but do meet the definition of a segment expense. Therefore, under these circumstances, research and development activities should not be designated as a separate segment and should be allocated in accordance with paragraph 16(f).

Another concern relates to the non-disclosure of pension liabilities as a segment liability. Under IAS 14, interest-bearing liabilities are not required to be allocated to the segments presented under the primary disclosure requirements. The standard on employee benefits, IAS 19, permits enterprises to disaggregate their pension cost among several income statement line items, for example, classifying the interest component as a financing expense. The staff recognizes that pensions have an interest component; however, pensions also have a significant component representing benefit obligations to employees of the business and geographic segments. The staff does not believe that there is interplay between IAS 14 and IAS 19. Therefore, a registrant should not assume that pension liabilities are interest-bearing obligations for purposes of excluding them from allocation to business or geographic segments.

Since IAS 14 requires the inclusion of direct and reasonably allocable expenses within segment result, the staff would object to the disclosure of non-GAAP measures of profitability such as operating profit before goodwill amortization within the IAS 14 disclosures. If, in this example, the registrant actually manages the business based on operating profit before goodwill amortization, that measure would be presented as part of the Item 18/FAS 131 segment disclosures.

I. IAS 38 - Intangible Assets

IAS 38 is effective for periods beginning on or after July 1, 1999. Intangible assets are to be amortized on a systematic basis over the best estimate of the intangible's useful life. There is a rebuttable presumption that the useful life of an intangible asset would not exceed 20 years from the date when the asset is available for use.

The rebuttable presumption within IAS 38 is a limited exception and depends on the facts and circumstances; however, the staff believes that only in *rare* cases will the 20-year rebuttable presumption be overcome. The staff believes that this is consistent with paragraph 83 of IAS 38. That paragraph states that there may be persuasive evidence that the useful life of an intangible asset will be a *specific period* longer than 20 years. This guidance contemplates assets such as the exclusive contractual rights granted for a specific period, for example, a long-term concession to operate a public utility. As such, the staff will object to the assertion that the expected life is in excess of 20 years but that the length of time in excess of that 20 years is not specific.

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Registrants using IAS 38 need to be sure that, contemporaneously with acquisition, they document their determination of the estimated life of an intangible asset, including the reasoning and basis for the conclusions reached. In addition, auditors should ensure sufficient, competent, and verifiable evidence is obtained to provide a basis for the auditor's conclusion that the estimated life management has chosen to assign to an intangible asset is reasonable and supportable.

J. Income Statement and Balance Sheet Presentation

IAS 1 allows an enterprise to present an analysis of expenses using a classification based on either the *nature* of expenses or their *function* within the enterprise. Under the nature of expense method, expenses are aggregated in the income statement according to their type (e.g., depreciation, purchases of materials, salaries, advertising, etc.) and are not reallocated among the various functions within the enterprise. On the other hand, the functional or "cost of sales" method classifies expenses according to their function as part of cost of sales, distribution, or administrative activities, for example. The functional method is generally required under Regulation S-X. In cases where expenses are classified based on their nature, sufficient disclosure about functional expense classifications should be presented as part of the US GAAP reconciliation to provide an information content substantially similar to an income statement presentation under US GAAP and Regulation S-X. This disclosure would be required both for Item 17 and Item 18 filers.

In several instances, enterprises have asserted that recurring expenses such as depreciation, amortization or changes in estimates of accrued liabilities should not be included in profit from operating activities. The staff believes the exclusion of these types of expenses is inappropriate and would object to the use of income statement line items such as "Operating Income Before Depreciation and Amortization" and Income Before Taxes and Amortization."

VII. Reporting Currency

A. Selection of Reporting Currency

Rule 3-20 of Regulation S-X permits a foreign private issuer to file financial statements prepared in any currency that management believes is appropriate. The rule requires disclosure of:

- the currency that is used to prepare financial statements prominently on the face of the financial statements;
- the currency that will be used to pay dividends if different from the reporting currency; and
- a description of material exchange restrictions or controls relating to the reporting currency, the currency of the issuer's domicile or the currency in which the issuer will pay dividends.

The rule does not apply to financial statements of acquirees or equity investees. However, these financial statements can be prepared either in

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the same currency as the issuer or in the currency that normally is used for preparation of such entities' financial statements. Accordingly, a domestic issuer can prepare financial statements of an acquiree or investee in US dollars.

B. Currency for Measurement

While there is effectively free choice in the selection of the reporting currency, there is not free choice in the selection of the currency used for measurement. All operations including the parent company that do not operate in a hyperinflationary environment should use the currency of their primary economic environment to measure transactions. While not specifically referring to FASB Statement 52, Rule 3-20 of Regulation S-X is conceptually consistent with that standard. That is, assets and liabilities are translated at the period end exchange rate, and the income statement is translated at the weighted average exchange rate. The translation effects of exchange rate changes are included in a separate component of equity.

C. Changes in Reporting Currency

1. General

Rule 3-20 requires the financial information for all periods presented in a filing to be stated in the same reporting currency. If an issuer elects to change its reporting currency, financial information for previous periods should be recast into the new reporting currency using a methodology consistent with FAS 52. The objective of this procedure is to present financial statements as if the issuer had always used the new reporting currency. This means that an issuer should translate income statements from the old reporting currency into the new reporting currency using weighted average exchange rates for the applicable period, and the balance sheets should be similarly translated using the applicable period end exchange rates. The methodology used should produce the same results as though the respective consolidating functional currency statements had been translated directly into the new reporting currency.

2. Reporting Currency Changes in Canada

Canadian issuers that elect to change reporting currency are encouraged strongly to discuss their particular facts and circumstances with the staff. Rule 3-20 of Regulation S-X states that the primary financial statements should be recast as if the new reporting currency had always been used. This method differs from the Canadian GAAP method, which uses a convenience translation to recast prior periods. The level of additional information that will be necessary to comply with the Commission's requirements will depend on the differences in exchange rates that would be used to recast prior periods. The additional information could range from addressing differences in the methodology as part of the reconciliation to US GAAP to complete restatement of prior year financial statements using the methodology required by Rule 3-20. Additional information in MD&A using the US GAAP balances also may be necessary.

3. Reporting in a Currency Different from the Registrant's Predecessor

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Rule 3-20 of Regulation S-X requires that the financial statements should be stated in the same currency for all periods presented. This requirement applies to financial statements of a predecessor as well as those of the registrant. That is, the reporting currency used in financial statements of the predecessor should be the same as that of the registrant.

D. Issues involving Euros

1. Presentation of Comparative Periods in Euros

As indicated in Topic D-71, the staff will not object if a registrant presents comparative financial statements for periods prior to January 1, 1999 by recasting previously reported financial statements into Euros using the exchange rate between the Euro and the prior reporting currency as of January 1, 1999.

Generally, when financial statements are stated in a currency different from the one used in previous filings with the Commission, SEC rules require a registrant to recast its financial statements as if the newly adopted currency had been used since at least the earliest period presented. However, Commission rules did not contemplate the introduction of a new, cross-border currency that would replace multiple existing currencies. Because the Euro did not exist prior to January 1, 1999, the retroactive application of the January 1, 1999 exchange rate to previously reported financial statements would not result in the remeasurement of previously reported results and therefore, would not alter previously reported trends and relationships.

It is important to note that the financial statements of multinational registrants that report in different currencies generally are not comparable. Recasting financial statements into Euros based on the January 1, 1999 exchange rate will depict the trends and relationships in a registrant's accounts in the same way as those trends and relationships previously were reported prior to the introduction of the Euro. However, because the recasted amounts do not take into consideration foreign exchange risk, investors may assume inappropriately that the financial statements of various registrants that report in Euros are directly comparable. Therefore, to highlight the potential lack of comparability in periods prior to January 1, 1999, the staff would expect that the disclosures outlined in Topic D-71 be made.

In addition, the staff believes that the use of the ECU (European Currency Unit) as a surrogate for the Euro for prior reporting periods would be inappropriate. The relationship between the legacy currency of a country participating in the EMU and the ECU would not necessarily have been the same as the relationship between the legacy currency and the Euro in periods prior to the introduction of the Euro. Therefore, the staff would object to the adoption of the ECU as the reporting unit for comparative periods prior to the introduction of the Euro as that would be likely to result in a remeasurement of the prior period amounts.

The staff will not object if a registrant that previously presented its financial statements in the currency of a country that is not an EMU member uses the Euro as its reporting currency, provided that the registrant follows the presentation and disclosure guidance in Topic D-71. A registrant reporting

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in Euros that has operations with functional currencies other than the Euro or EMU legacy currencies will experience foreign currency translation effects for periods after January 1, 1999. These effects should be disclosed in the financial statements and highlighted in MD&A.

2. Staff Legal Bulletin 6 - Euro Disclosures

The staff issued Legal Bulletin No. 6 on July 22, 1998. That legal bulletin outlines certain disclosure obligations under existing Commission rules that may require a discussion of the impact of the euro conversion in, for example, the description of business, MD&A and the market risk disclosures. This guidance applies not only to foreign private issuers but also to domestic registrants with material European operations or transactions. The legal bulletin is available on the SEC web site.

E. Convenience Translations

SEC rules permit, but do not require or encourage, presentation of a convenience translation. If a convenience translation is presented, Rule 3-20(b) of Regulation S-X specifies that the translation should be presented using the exchange rate as of the most recent balance sheet included in the filing, except that a rate as of the most recent practicable date shall be used if materially different.

Various Asian currencies declined significantly in value subsequent to December 31, 1997. The staff has received questions regarding the applicability of the guidance in Rule 3-20(b) to registrants that report in a currency with a significant decline after the balance sheet date. Some believe that literal application of the rule using the more recent rate could result in a potentially misleading presentation. For example, if a registrant's debt were denominated in US dollars or other major currencies, the convenience translation would depict the debt at a much lower US dollar amount than the registrant's actual debt service requirements.

The staff will not object if a registrant uses the exchange rate at the date of the most recent balance sheet in preparing a convenience translation for inclusion in an annual report on Form 20-F or a registration statement, or if it omits a convenience translation. The staff also will not object if a registrant uses a more current exchange rate. However, all amounts presented for a given period must be translated using the same exchange rate. If convenience translations are presented in a registration statement that includes all required financial statements, such as Form F-1, the same exchange rate should be used for the most recent fiscal year presented and any subsequent interim period. If a registrant files a registration statement that incorporates by reference financial statements previously filed on Form 20-F, the staff will not require amendment of the previously filed financial statements to reflect a convenience translation based on a more current exchange rate.

In any event, registrants should highlight a material currency devaluation and provide full, balanced disclosures regarding its effects on the registrant's results of operations, liquidity, and cash flows in MD&A. Also, FAS 52 requires disclosure of significant changes in currency exchange rates occurring after the balance sheet date and the effects on unsettled balances pertaining to foreign currency transactions.

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F. Reporting Currency for Domestic Registrants and non Foreign Private Issuers

Regulation S-X presumes that a US-incorporated registrant will present its financial statements in US dollars. In rare instances, the staff has not objected to the use of a different reporting currency. Those instances have been limited to situations where the US-incorporated registrant had little or no assets and operations in the US, substantially all the operations were conducted in a single functional currency other than the US dollar, and the reporting currency selected was the same as the functional currency. In these circumstances, reporting in the foreign currency would produce little or no foreign currency translation effects under FASB Statement No. 52. The staff has also not objected when a foreign issuer who does not meet the definition of a foreign private issuer applies this approach in similar circumstances.

VIII. Other Disclosure Issues and Staff Interpretations

A. Updating Interim Financial Information -- Item 8.A.5 of Form 20-F

NOTE - Rule 3-19(f) was superceded by Item 8.A.5 of Form 20-F and related instructions beginning October 1, 2000. The disclosure requirements of Rule 3-19(f) have been retained in the new Item and the staff intends to continue to interpret the requirements as described below.

Item 8.A.5 requires interim financial information that is made available to shareholders, exchanges or others on a more current basis than that otherwise required by SEC rules to be included in the registration statement. This information is not required to be reconciled to US GAAP. However, narrative disclosures about differences in accounting principles are required and material reconciling items that have not been previously addressed in the filing must be quantified. The intent of the disclosure is to ensure that the information available to a US investor is as current as information available to a foreign investor.

Item 8.A.5 should not be interpreted as limiting the disclosure only to information on revenues and income. Rather, if the information disclosed in the foreign jurisdiction includes revenues and income, then all financial information that is made public should be included in the registration statement.

Item 8.A.5 applies to annual as well as interim financial information. For example, if the foreign issuer publicly distributes annual financial information before the audited statements are available, the registration statement should include such information.

Occasionally, the interim information that is publicly distributed in the issuer's home country will be prepared using accounting standards that are different from those used in the US registration statement. In this instance, the US investor has not had the benefit of knowing the reconciling items between home-country GAAP and US GAAP. Therefore, the information disclosed pursuant to Item 8.A.5 would have to be supplemented with a description and quantification of differences in accounting principles.

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For example, a foreign issuer uses US GAAP in its primary financial statements in filings with the Commission, but reports in a foreign GAAP in its home country. The company releases more recent earnings information in its home country in foreign GAAP. Item 8.A.5 requires that information to be included in the prospectus. However, the issuer has never filed reconciliations from foreign GAAP to US GAAP, so a US investor cannot interpret the foreign GAAP information. In this situation, an issuer may either (a) reconcile the Item 8.A.5 information to US GAAP or (b) provide a reconciliation from US GAAP to foreign GAAP (reverse reconciliation) for fiscal at least the most recent year required in the registration statement.

Issuers occasionally will be required to adopt a new US accounting standard in their first interim financial statements. The disclosure of financial information required by Item 8.A.5 does not result in the requirement to adopt the new standard and quantify its effect under US GAAP.

Item 8.A.5 information does not trigger a requirement to include full interim financial statements more recent than otherwise required. For example, if complete financial statements related to the most recent quarter (but not the comparative period) are distributed in a foreign issuer's home country, that information must be included in the US registration statement. Comparative prior period information is not required because the information provided is included only because of Item 8.A.5. In order to avoid confusing US readers, the registrant should include disclosure explaining why the information is provided particularly when the information is placed with other financial statements and may look incomplete. If the information provided contains a reconciliation to US GAAP, the staff believes that inclusion of reconciled information for the comparative prior periods generally will also be necessary to prevent the current period information for being misleading.

B. Changing to US GAAP for the Primary Financial Statements

A registrant that loses its foreign private issuer status becomes subject to the reporting requirements for a domestic company on that date. While previous Exchange Act reports do not need to be amended upon the loss of foreign private issuer status, all future filings are required to fully comply with the requirements for a domestic company. The financial statements and selected financial data should be recast into US GAAP and US dollar reporting currency for all periods presented. The first filing containing US GAAP financial statements should set out in full the accounting policies under US GAAP that the registrant has adopted.

Similarly, when a registrant voluntarily changes from home-country GAAP to US GAAP all periods must be restated. The timing of the restatement will depend on whether the registrant has also voluntarily elected to file on domestic forms. If so, the change is ordinarily made in the first quarter of a new fiscal year. The first Form 10-Q and each subsequent Form 10-Q should reflect US GAAP in all current and comparative interim periods presented. The annual comparative periods are then recast when the next annual report is filed.

However, the timing of the restatement will be accelerated in the event of a registration statement. Interim financial statements included in a registration statement must be prepared on the same basis of accounting

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and reporting currency as the annual financial statements, so all comparative interim and annual periods must be restated at that time. This is true even if a registrant is eligible to incorporate previously filed documents by reference.

C. Pro Forma Information that Departs from Article 11 of Regulation S-X

A foreign regulator may require presentation of certain "pro forma" information that may be a mixture of historical and forecasted amounts or otherwise not comply with Article 11 of Regulation S-X. For example, it might eliminate the impact of certain charges such as restructurings or recalculate revenues based on new sales contracts. Since the information is included in the foreign prospectus, the registrant may conclude that the information must also be included in the US prospectus so that the same information is disclosed to all investors. Although the presentation does not comply with Article 11, the staff has not objected to the disclosure in the US registration statement provided the information indicates clearly what the presentation represents, states that this pro forma information does *not* comply with Article 11 and explains why the information is included.

In some countries, compilation reports by independent accountants on pro forma information may be included in registration statements used in cross-border offerings pursuant to requirements in the foreign country. While such reports normally would not be allowed in US filings, the staff will not object to the inclusion of a compilation report provided that the registration statement includes a statement from the independent accountants that addresses the following items:

- the opinion is included solely to comply with the requirements of the particular jurisdiction;
- US GAAS does not provide for an expression of an opinion on a compilation of pro forma financial statements;
- to report in conformity with US GAAS, an examination greater in scope than that performed would be required; and
- no opinion is expressed under US GAAS.

Presentation of these comments in the manner in which the Canadian Institute of Chartered Accountants recommends for differences between US and Canadian reporting standards would be acceptable. The registration statement should include a letter from the independent accountants acknowledging the use of the report.

D. Disclosure in Specialized Industries

1. Disclosure by Banking and Insurance Companies

Foreign banks will frequently have difficulty obtaining certain information to comply with the statistical disclosure requirements of Industry Guide 3. The staff recognizes that the categories and classifications specified by Guide 3 are heavily influenced by US banking regulation, and that some categories

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and classifications may not be the most relevant in understanding a foreign bank's operations. The staff will generally accept alternative classifications and presentation formats that provide an information content substantially similar to that specified by Guide 3, and may grant accommodations on the number of periods to be presented in certain circumstances. However, the staff believes that a robust presentation about loan quality and loss reserving is critical to an investor's understanding, and will pay particular attention to the completeness and meaningfulness of the information provided in response to Items III and IV of the Guide.

Foreign insurance companies will often have difficulty obtaining sufficient data regarding property casualty (general insurance) claim reserves to prepare the 10-year loss reserve development table in Industry Guide 6. When appropriate, the staff has granted limited accommodations on the number of periods to be presented. The staff will also consider presentations that encompass substantially all of the loss reserves, if the registrant lacks sufficient data in certain jurisdictions with small operations.

2. Oil and Gas Full Cost Ceiling Test

US oil and gas companies are required to file quarterly reports containing full cost ceiling tests under Rule 4-10(c) of Regulation S-X. Foreign registrants generally are not required to file quarterly reports. As a result, the staff does not object to foreign registrants limiting the application of the full cost ceiling test to the periods in which US GAAP balances are provided. In the event that comparative interim information is included in a registration statement for a period that was not previously presented, the full cost write-down for the interim period would be the lesser of the write-down for the year, or the excess over the ceiling amount at the end of the interim period. Foreign registrants should disclose the frequency with which the ceiling test is performed and the date of the latest test.

3. Mining Reserves and Depletion

Mining companies should provide explicit disclosure of the types of reserves that are included in the base used for computing depletion - proven and probable reserves. The Commission has indicated in Industry Guide 7 that disclosure of reserve information is limited to proven and probable reserves. As disclosure of possible reserves is prohibited by Commission rules, the base of depletion should also not include such amounts. Excluding possible reserves from the base may result in a difference from home-country GAAP that needs to be addressed in the reconciliation to US GAAP.

E. Disclosure about New Accounting Rules

A number of significant IAS standards with extended transition dates have been issued in recent years. Certain other countries, such as the UK, also have substantial recent standard-setting activity.

Staff Accounting Bulletin 74 requires that when a new accounting standard has been issued but has not yet been adopted, the registrant should discuss the effect that the new standard will have on the registrant's financial statements when adopted. If alternative adoption methods and

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dates are permitted, the registrant should indicate the anticipated method and adoption date.

The SAB 74 disclosure requirement applies not only to the US GAAP information presented by foreign registrants but also to the GAAP used to prepare the primary financial statements included in SEC filings. The following disclosures should be provided:

- A brief description of the new standard, the date that adoption is required, and the date the registrant plans to adopt the standard, if earlier;
- A discussion of the method of adoption allowed by the standard and the method expected to be utilized by the registrant, if determined; and
- A discussion of the impact that adoption of the standard is expected to have on the financial statements, unless not known or reasonably estimable. In that case, a statement to that effect should be made.

In addition, disclosure of the potential impact of other significant matters that the registrant believes might result from the adoption of the new standard (e.g., technical violations of debt covenants, planned or intended changes in business practices) is encouraged.

In a number of the IAS standards, the impact of adopting the new or revised standard is likely to be known because similar determinations are necessary to prepare the US GAAP reconciliation.

F. Management Discussion and Analysis

1. Effects of Accounting Methods on Reported Results and Liquidity

In certain circumstances, the unusual nature or highly material amount of a particular US GAAP reconciling item warrants further MD&A disclosure based on the guidance in Staff Accounting Bulletin 88. In these situations, the following factors may indicate the need for additional MD&A disclosure:

- Significant differences in key financial indicators highlighted in the home-country GAAP disclosures but not ordinarily required to be reconciled, such as revenues or operating income.
- Differences resulting in a significant divergence of trends between key home-country GAAP and US GAAP amounts.
- Differences that are likely to grow significantly in future periods because they relate to outstanding long-term contracts with fixed terms.
- Differences related to specialized industry accounting that may be unfamiliar to US investors, particularly where home-country GAAP would not ordinarily be expected to produce significant differences.

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- Significant differences reflected in the separate financial statements of a recently acquired business that are not yet fully reflected in the registrant's financial statements.

- Differences reflected in the separate financial statements of an equity method investee, whose effects are not fully apparent in the registrant's financial statements.

An expanded presentation of selected financial data on a US GAAP basis also may be necessary in these circumstances to highlight unusual or highly material matters that otherwise might not be disclosed with sufficient prominence.

2. UK GAAP and Market Risk Disclosures

UK Financial Reporting Standard 13 "Derivatives and other financial instruments: disclosures" requires certain quantitative and qualitative information about market risk to be included in, or incorporated into, the audited financial statements. Similar information is required to be presented under the SEC's market risk disclosure rules (Item 11 of Form 20-F) but General Instruction 6 of that Item states that such information must be presented outside of, and not incorporated into, the financial statements.

The staff has determined that it will waive the requirement of General Instruction 6 to Items 11(a) and 11(b) of Form 20-F that the quantitative and qualitative information about market risk be presented outside of, and not incorporated into, the financial statements. This waiver is limited solely to those disclosures under Items 11(a) and 11(b) whose inclusion or incorporation in the financial statements is necessary for compliance with FRS 13.

3. Sony Enforcement Release

In August 1998 the Commission issued a cease and desist order against Sony Corporation. The Commission found that Sony violated the periodic reporting requirements of the Exchange Act of 1934. The Commission issued a similar order against Sony's Director of Investor Relations who was found to be a cause of the violations.

The Commission found that during the four months preceding Sony's $2.7 billion goodwill writedown related to its Sony Pictures subsidiary in November 1994, Sony made inadequate disclosures about the nature and extent of Sony Picture's losses and their impact on consolidated results. These deficiencies were contained in the MD&A to Sony's annual report on Form 20-F for the year ended March 31, 1994, as well as in two Form 6-Ks that included copies of Sony's quarterly earnings releases.

Sony Pictures experienced significant losses throughout the periods since its acquisition, but those losses were not disclosed. Instead, disclosures about Sony Pictures focused on positive aspects like revenue trends and Academy Award results. The SEC noted that Sony did not report Sony Pictures as a separate industry segment, but instead combined its results with Sony's highly profitable music business as a single "entertainment"

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segment, thus obscuring the large losses of Sony Pictures.

The Commission ordered Sony to cease and desist from periodic reporting violations and to comply with three undertakings:

- to engage an independent auditor to examine its MD&A,
- to adopt procedures to ensure that Sony's chief financial officer (rather than the Investor Relations officer) will be the primary official responsible for ensuring compliance with public reporting requirements, and
- to continue to apply recently adopted FAS 131 for its segment reporting.

The Commission also sought and obtained a $1 million civil penalty in a related federal court proceeding.

IX. Reporting in Highly Inflationary Economies

A. Price-Level Adjusted Financial Statements

1. General

Various countries that have experienced high rates of inflation require or permit financial statements to comprehensively include the effects of price level changes under home-country GAAP. In some countries, that reporting continues to apply even though the cumulative three-year inflation rate may be below 100%. The most commonly used approach is historical cost/constant currency, which recasts comparative period amounts into equivalent units of current purchasing power using a general price-level index. In some countries, a current (replacement) cost approach may be used. Form 20-F permits the inclusion of comprehensive price-level adjusted financial statements in SEC filings where that reporting is required or permitted by home-country GAAP.

Price-level adjustment approaches differ fundamentally from the methods used to translate historical cost results of foreign operations under FAS 52. Because of the inherent difficulties in producing meaningful information, an accommodation in Form 20-F permits foreign registrants that prepare comprehensive price-level adjusted financial statements to *not* reconcile the effects of price level changes to US GAAP. Registrants who use this accommodation must describe the basis of presentation of the price-level adjustments, and must state that the effects of the price level adjustments have not been reconciled to US GAAP.

2. Price Level Adjusted Financial Statements under US GAAP - APS 3

Foreign private issuers operating in a highly inflationary environment that would like to prepare their primary financial statements in accordance with US GAAP can apply APB Statement No. 3, *Financial Statements Restated for General Price-Level Changes*. The effects of the application of price level accounting do not have to be quantified in the reconciliation to US GAAP, as APS 3 is US GAAP. The staff has addressed several issues regarding the

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application of APS 3 including the acceptability of netting certain costs, discounting of trade receivables and payables and capitalization of interest. The definition of "highly inflationary" in FAS 52 and Rule 3-20 of Regulation S-X should be used when applying APS 3.

3. Updating Price Level Adjusted Financial Statements

All price level adjusted financial information in a foreign private issuer's registration statement should be presented in equivalent purchasing power units of the reporting currency. That is, all measurements are restated retroactively to the purchasing power unit at the date of the most recent balance sheet in the filing. If a company updates to include interim financial information, the prior annual financial information must be recast in equivalent purchasing power units. A company that incorporates by reference a prior annual report on Form 20-F need not amend the prior filing, but must file restated financial statements in the registration statement or under cover of a Form 6-K that is incorporated by reference.

Many historically inflationary economies have experienced declining rates of inflation in recent years. If the rate of inflation during the interim period is very low such that the effect of restatement does not materially affect apparent trends and is clearly immaterial (for example, 3% or less), the staff has not insisted that prior period financial information be restated. If the information is not restated, the rate of inflation and the reason why restatement was not considered to be necessary should be disclosed.

If the interim information is included in a registration statement solely because more recent interim financial information than otherwise required by Item 8.A.5 of Form 20-F was published, the staff encourages but will not insist that prior periods be restated in units of equivalent purchasing power as of the most recent date. Registrants should provide disclosure necessary to prevent the updated data from being misleading in relation to prior period financial information. For example, the issuer should provide supplemental selected financial data recast in equivalent purchasing power units, accompanied by disclosure of the rate of inflation that would be used to restate all prior financial information in equivalent purchasing power units.

4. Price-Level Adjusted Cash Flow Statements

FASB Statement 95 and Form 20-F do not address the presentation of the statement of cash flows by registrants that prepare price-level adjusted financial statements in filings with the SEC.

Inclusion of the effects of inflation in the line items comprising the three major categories of the cash flow statement may make the presentation less meaningful and possibly misleading. For example, the financing activities section may depict reductions of foreign-currency denominated debt because of the recasting of prior balance sheet amounts for inflation, even though no cash repayment has occurred. In some cases, these effects may permeate the statement of cash flows. However, presentation of a "fourth caption" that comprehensively segregates the effects of inflation/currency devaluation from the cash flows from operating, investing and financing activities has been adopted in several countries (Chile, Columbia).

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Registrants are required to prepare price-level adjusted cash flow statements in a manner that comprehensively segregates the effects of inflation from the cash flows from operating, investing and financing activities. The November 1998 AICPA International Practices Task Force minutes include an illustrative example. Because of the difficulties of retroactive compliance, this guidance should be adopted for fiscal years *ending* after November 1998. Recasting of comparative periods is encouraged but not required.

B. Determining whether an Economy is Highly Inflationary for FASB Statement 52

1. General

Where an economy's cumulative three-year inflation rate has increased to 100% or more, EITF Topic D-55 "Determining a Highly Inflationary Economy under FAS 52" states that the economy should be considered highly inflationary in all instances. Where the inflation rate has fallen below 100%, EITF Topic D-55 states that "historic inflation rate trends (increasing or decreasing) and other pertinent factors should be considered to determine whether such information suggests that [continued] classification of the economy as highly inflationary is appropriate." A change in status from highly inflationary to non-highly inflationary is implemented at the beginning of the reporting period that immediately follows the date the economy is determined to be no longer highly inflationary.

Before Topic EITF D-55 was announced in November 1996, practice was inconsistent and some issuers did not make these types of changes for extended periods. The staff believes that similarly situated issuers should reach reasonably consistent judgments about when an economy ceases to be highly inflationary. The longer the period and the greater the amount by which the three year cumulative inflation rate is below 100%, the more difficult it will be for "other pertinent factors" to outweigh a conclusion that the economy is no longer highly inflationary.

Registrants with material operations in an economy that is no longer considered highly inflationary should provide the following disclosures in the financial statements and MD&A:

- a description of the economy's status as a highly inflationary economy,
- the date the economy ceased being considered a highly inflationary economy,
- the functional currency used by those operations, and
- the effects on the financial statements of the change in the functional currency, if practicable.

C. Other Reporting Questions

1. Reporting in US Dollars

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Like all foreign private issuers, registrants based in countries with highly inflationary economies are permitted by Form 20-F to present US GAAP financial statements in US dollars. The amounts presented for non-monetary assets and liabilities as well as total stockholders' equity should not be materially different than if the US dollar had always been used as the reporting currency, and thus the currency for measurement, during the period that the economy is highly inflationary as defined by FAS 52. Under US GAAP it is not acceptable to use price level adjusted financial statements expressed in local currency and then translate those amounts into US dollars.

2. Accommodation for IAS 21 for Highly Inflationary Foreign Operations

As specified in Form 20-F, foreign registrants that account for operations in a highly inflationary economy in a manner consistent with IAS 21, using the historical cost/constant currency method, need not quantify differences in the translation methodology compared to US GAAP. FAS 52 requires financial statements of an entity in a highly inflationary economy to be remeasured as if the functional currency were the reporting currency. Under IAS 21, the financial statements of the entity in the highly inflationary economy would first be adjusted for inflation and then translated into the reporting currency using the period end exchange rate.

The rule defines highly inflationary economy in a manner consistent with FAS 52 - cumulative inflation of approximately 100% over the most recent three-year period. This definition of a highly inflationary economy and the limitation of using the historical cost/constant currency method does not apply to issuers that prepare financial statements in a reporting currency that comprehensively includes the effects of inflation.

X. Privatizations of Government-Owned Enterprises

Significant accounting and reporting issues often arise in connection with the privatization of a government-owned enterprise. Where appropriate, the staff will provide accommodations consistent with the particular circumstances and the protection of investors.

A. Predecessor Financial Statements

The staff has waived certain financial statement requirements when the issuer or significant acquiree changed from a state-owned and operated enterprise to one that operates in a market-based economy. This may occur when a government privatizes an industry, or when fundamental changes occur in the economy itself. The waiver generally applies to periods preceding the time that the fundamental change occurred. In determining whether relief is appropriate in a particular situation, the staff considers the following:

- the impossibility of obtaining reliable financial information because the necessary records were never maintained and cannot be developed, and
- more importantly, the lack of relevance to an investor because of

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significant changes to the entity and its environment. The evaluation generally is made using criteria similar to those in Rule 11-01 of Regulation S-X.

B. Selected Financial Data

The staff has waived selected financial data for periods preceding those covered by the audited financial statements in circumstances where it was impracticable to obtain the earlier years. This accommodation is generally limited to situations where there have been significant changes in the issuer's operations. Where reliable and relevant to an understanding of trends, presentation of revenues or non-financial operating statistics may be required for the earlier years.

C. Fixed Asset Valuations

Government-owned enterprises may use expenditure-based accounting systems in which perpetual fixed asset records are not maintained. Where reliable fixed asset records are not available and cannot reasonably be produced, the staff has not objected to the establishment of fixed asset amounts based on fair values at the opening balance sheet date. In these circumstances the staff expects the issuer to undertake a rigorous process of identification and appraisal of the assets. The opening fair value balances are considered to be the registrant's cost basis, and thereafter the assets are reported in the usual manner with respect to recognition of depreciation and evaluation of impairment. Ordinarily, the auditor's report will include an "except for" qualification regarding conformity to US GAAP related to this matter. A qualification, in these particular circumstances, would be acceptable to the staff.

D. Restructuring Activities

A government-owned enterprise may close facilities, curtail activities, change its methods of doing business, or alter its pension plans or other arrangements with employees in connection with a privatization. The changes may be initiated by the issuer or required by the government. These changes may result in recognition of significant balance sheet accruals or income statement charges under home country GAAP. Issuers should be aware that significant differences in amounts, timing and classifications might arise under US GAAP. For example, issuers should carefully consider the requirements of FASB Statements 87, 88, 106, and 121, EITF 94-3, SAB 100 and related pronouncements. MD&A should clearly explain the effects of these types of transactions on reported results and the expected impact on future operations, liquidity and cash flows. Additional MD&A discussion may be necessary to address significant differences between home country and US GAAP results.

E. Issuances of Government-owned Shares to Employees

Frequently, the government shareholder will offer shares to employees of the issuer at a discount in connection with a privatization. These transactions generally are not considered compensatory events under home-country GAAP. However, Interpretation 1 to APB Opinion 25 requires the costs of employee compensation plans offered by a significant

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shareholder to be reflected in the company's financial statements except in certain limited circumstances. Interpretation 1 does not specifically address stock grants related to privatization transactions.

In evaluating these transactions, the staff first considers whether the issuance meets the conditions of a non-compensatory plan in paragraph 7 of APB Opinion 25. If the shares are offered to substantially all employees on an equal basis, there are no continuing performance or employment (vesting) conditions, and the discount from market (offering) price is reasonably small, the issuance would not be considered compensatory. Otherwise, the staff believes that Interpretation 1 should be applied, and an income statement charge should be reflected under US GAAP for the difference between market price and the employees' purchase price. The staff generally would not expect a government shareholder to meet any of the three exceptions in Interpretation 1.

The staff recognizes that privatization transactions are influenced by various economic, social, and political goals, and that compensation of employees is not their primary purpose. Where the issuance is concurrent with the privatization transactions, accomplished in a single reporting period, and will not result in periodic income statement charges, the staff has not objected to characterization of the charge as an extraordinary item.

F. Oil & Gas Properties

Some governments do not permit private parties to own oil & gas properties. Instead, the governments grant leases or concession rights to explore, develop and produce the underlying oil & gas reserves. Those rights are usually granted for a fixed term, which may be shorter than the estimated period required to extract the underlying reserves.

For purposes of determining proved reserves under FAS 19, FAS 69 and Rule 4-10 of Regulation S-X, a registrant's estimate of oil & gas reserves should be limited to quantities expected to be produced during the term of its leases or concessions. Renewals should not be assumed unless the registrant has a demonstrated history of obtaining renewals.

XI. Domestic Issuers With Acquired Foreign Businesses

A. Rule 3-05 and 3-09 Reconciliation Requirements

Rule 3-05 and 3-09 of Regulation S-X provide domestic registrants that prepare financial statements for an acquiree or an investee that is a foreign business, as defined, the same accommodations that foreign registrants have. Specifically, these financial statements would not be required to include a reconciliation to US GAAP unless the significance level exceeds 30%. In such situations, the reconciliation can be prepared in accordance with Item 17 of Form 20-F. In addition, the age of financial statements of a foreign business can be the same as a foreign private issuer. The accommodations regarding age of financial statements of a foreign business apply to filings under both the 1933 and 1934 Acts. Audited financial statements of equity investees that are foreign businesses can be filed six months after the investee's fiscal year end.

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The definition of a foreign business is similar to, but not the same as, the definition of a foreign private issuer. One of the primary differences is that majority ownership by US citizens or residents will disqualify a business from foreign business status regardless of the other attributes. A foreign subsidiary of a US company is not a foreign business. The ownership and officer/director criteria in the definition of a foreign business are based on the attributes of the ultimate holding company. Under this definition, an entity that is 50% owned by a domestic entity and 50% owned by a foreign entity would not be deemed to be a foreign business even though it may be exclusively located outside the US. The definition of a foreign business is designed to provide the accommodations where the acquiree or investee would not reasonably be expected to have US GAAP information or be subject to US reporting requirements. As stated in footnote 31 to Release 33-7118, if the acquired business or investee does not meet the foreign business definition, the issuer can file financial statements prepared in accordance with home-country GAAP provided a reconciliation to US GAAP under Item 18 is included regardless of the level of materiality.

The accommodation to not reconcile separate financial statements of less than 30% significant equity investees does not affect a domestic issuer's measurement of earnings or disclosures under Regulation S-X. APB Opinion 18 requires equity investees to be accounted for using US GAAP. Further, Release 33-7118 requires summarized data under Rule 4-08(g) to be presented in accordance with US GAAP.

These accommodations apply to financial statements required by Rule 3-05 and 3-09 of Regulation S-X but do not apply to financial statements of a predecessor of a registrant. If the registrant is not a foreign private issuer, predecessor financial statements must be prepared in accordance with US GAAP and Regulation S-X applicable to domestic issuers.

B. Effect of Recent Amendments to Form 20-F

Release No 33-7745, which sets out the final rules on International Disclosure Standards and the changes to Form 20-F, also conforms the age of financial statement requirements under Rules 3-05 and 3-09 for foreign business acquirees and investees to those in Item 8 of Form 20-F. These conforming changes apply to both foreign and domestic registrants. However, the release does not address when these changes need to be adopted by domestic issuers.

The new requirements should be applied to all financial statements of foreign business acquirees and investees required in registration statements first filed after September 30, 2000, and to all financial statements of foreign business acquirees required in Form 8-Ks filed after September 30, 2000. The filing date is based on the Form 8-K initially reporting consummation of the acquisition.

Appendix — Country Specific Issues

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I. Canada

A. MJDS

Under the Multi-Jurisdictional Disclosure System, Form F-10 for Canadian issuers requires *any* financial statements included in the registration statement to be reconciled to US GAAP using Item 18 of Form 20-F. A literal application of the instructions would result in MJDS filers reconciling interim information on a more current basis than Canadian or other foreign private issuers filing on the regular system. The staff will not object if a MJDS issuer reconciles to US GAAP only those periods that would be required if the filing was made on a regular foreign form. That is, the issuer may apply the age of financial statement requirements in Item 8 of Form 20-F.

Similarly, the staff will not object if financial statements of entities other than the registrant that are included in the Form F-10 are reconciled to US GAAP in the manner that would apply to a filing on a regular foreign form. For example, financial statements of foreign business acquirees or equity method investees need only be reconciled if they are significant at the 30% level, and the reconciliation may be based on Item 17 of Form 20-F. Under the MJDS rules, the inclusion of an entity's financial statements in Form F-10 is based on Canadian filing requirements. SEC financial reporting requirements such as Rules 3-05 and 3-09 of Regulation S-X do not apply to MJDS filings.

B. Flow Through Shares

Small Canadian exploration stage companies typically issue "flow through shares". The shares permit the investor to claim deductions for tax purposes related to expenditures incurred by the issuer. The issuer explicitly renounces the right to claim these deductions. The investor's tax basis is reduced by the amount of deductions taken.

The Canadian Institute of Chartered Accountants recently issued a new standard on income taxes (Section 3465 of the Handbook). Under the new Canadian GAAP standard, shares are recorded at their face value when issued. When the entity acquires assets the carrying value may exceed the tax basis as a result of the enterprise renouncing the deductions to the investors. The tax effect of the temporary difference is recorded as a cost of issuing the shares.

The FASB staff has taken the view that under FAS 109 the proceeds from issuance should be allocated between the offering of shares and the sale of tax benefits. The allocation is made based on the difference between the quoted price of the existing shares and the amount the investor pays for the shares. A liability is recognized for this difference. The liability is reversed when tax benefits are renounced and a deferred tax liability is recognized at that time. Income tax expense is the difference between the amount of the deferred tax liability and the liability recognized on issuance.

Attachment B to the minutes of the November 1999 meeting of the AICPA International Practices Task Force illustrates the differences between the Canadian GAAP model and the FASB staff model. The SEC staff expects

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registrants to follow the FASB staff model for US GAAP purposes.

II. Mexico

A. Pensions

Bulletin D-3 addresses pension accounting under Mexican GAAP. The guidance is generally similar to FASB Statement 87. Bulletin D-3 specifies the use of real (net of inflation) rates in determining plan assumptions. For purposes of reconciling to US GAAP, Mexican registrants should use real rates and treat the pension plan liability/asset as non-monetary.

B. Deferred Profit Sharing

Prior to issuance of Bulletin D-4 in Mexico effective January 1, 2000, two methodologies for accounting for deferred profit sharing were in use in Mexico. Some registrants use an accrual methodology and others use a balance sheet methodology. Under the *accrual methodology*, a liability is recognized for deferred employee profit sharing purposes on timing differences between income for financial reporting purposes and income for purposes of computing the current amount of the employee profit sharing payment. The *balance sheet methodology* determines the liability based on the difference between assets and liabilities in the financial statements and assets and liabilities determined in accordance with the law relating to the employee's profit sharing. This methodology is conceptually consistent with FAS 109.

For US GAAP purposes, beginning January 1, 1997, all registrants should calculate deferred employee profit sharing plan obligations using the balance sheet methodology. It would be inappropriate for a registrant to change from the balance sheet methodology to the accrual methodology.

Bulletin D-4 (effective January 1, 2000) requires the accrual methodology. As a result, a US GAAP reconciling item is necessary to report the effects of the use of a balance sheet methodology. Profit sharing expense should be classified as an operating expense for purposes of the US GAAP reconciliation.

C. Consolidation of Foreign Subsidiaries

Mexican Accounting Principles Commission Bulletin B-15 requires Mexican companies to report the assets and operations of consolidated foreign (non-Mexican) subsidiaries by price-level adjusting the accounts based on the inflation rate in the foreign country, then translating into pesos using the year-end exchange rate. For example, a Mexican registrant with a US subsidiary would price-level adjust that subsidiary by the US inflation rate, not the Mexican inflation rate. This method applies to all comparative periods presented. Thus the unit of measure (reporting currency) for the financial statements is impacted over time by the location and relative size of a Mexican registrant's foreign subsidiaries. The Bulletin B-15 method differs from the approach in virtually all other countries that permit or require price-level adjusted accounting.

The issue is whether the methods of consolidation and translation specified

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by Bulletin B-15 under Mexican GAAP are consistent with (1) a comprehensive basis of price-level adjusted accounting, and (2) the requirement of Rule 3-20(e) of Regulation S-X to present financial statements for all periods in the same reporting currency.

For the most recent period being presented, the methods specified by Bulletin B-15 are considered to be consistent with a comprehensive basis of price-level adjusted accounting. For the most recent period being presented, the staff has not objected to the use of the accommodation in Form 20-F that permits registrants to not remove the effects of inflation accounting when reconciling to US GAAP.

The staff believes that the Bulletin B-15 methods do not comply with Rule 3-20(e) with respect to comparative periods. However, since Bulletin B-15 accomplished the goal of establishing consistent principles for Mexican companies, and there is no definitive guidance in US GAAP, the staff has not objected to comparative financial statements prepared in conformity with Bulletin B-15, provided that the registrant quantifies the aggregate effects of the departure from Rule 3-20(e) in its reconciliation to US GAAP and includes the following disclosures:

- The reconciliation of net income and shareholders' equity should include a one-line adjustment for the difference in methodologies of restating prior year balances. This amount represents the difference between (i) the balances if all amounts were adjusted by the Mexican inflation rate, and (ii) the balances used in the primary financial statements to comply with Bulletin B-15.

- The additional disclosures provided will depend on the methodology that is used to restate prior year balances - Method A or Method B. Under Method B, as all numbers are multiplied by the same index, it is easier to determine the effect of applying B-15 to each reported amount.

  - Method A - Present a balance sheet, income statement and statement of cash flows in a level of detail that complies with Article 10 of Regulation S-X. The amounts presented should be expressed in pesos of equivalent purchasing power using the Mexican inflation rate and presented on a basis that reflects all US GAAP adjustments. All other US GAAP adjustments for prior periods should be presented in constant pesos of equivalent purchasing power using the Mexican inflation rate.

  - *Method B* - Present summarized financial information in at least the detail specified in Rule 1-02(bb) of Regulation S-X (sales, gross profit, net income, current assets, non current assets, current liabilities and non current liabilities) plus the major captions in the cash flow statement (operating, investing, financing, and if applicable, the effect of inflation on cash). Amounts should be presented in pesos of equivalent purchasing power using the Mexican inflation rate on a basis that reflects all US GAAP adjustments. The cash flow information should be presented in a manner that reconciles beginning and ending cash and cash equivalents. To allow a reader to determine the effect of the methodology used in B-15 compared to US GAAP, disclosure should be provided as to the differences in the

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index that was used to recast prior year balances and the index that would be used under US GAAP based on the rate of Mexican inflation.

- The method used to restate prior year balances should be disclosed in the financial statements.

- Selected financial data under US GAAP should be presented for all comparative periods that were recast using the Mexican inflation rate.

D. Fixed Assets of Non-Mexican Origin

The method permitted by the Fifth Amendment to Bulletin B-10 for restating fixed assets of foreign origin is not consistent with a comprehensive basis of price-level adjusted accounting. The staff has concluded that a reconciling difference should be reported based on the amount using the Mexican consumer price index.

E. Inflationary Status

For periods beginning after December 31, 1996, Mexico was considered a highly inflationary economy. For periods beginning after December 31, 1998, Mexico is no longer considered highly inflationary.

III. South America

A. Brazil

1. Price Level Index

In 1995 the staff became aware that numerous inflation indices were being used to prepare financial statements in Brazil and those indices varied considerably. In order for financial statements of registrants to be comparable, the IGP index should be used. Companies that are registered with the SEC should use the IGP index prospectively in financial statements of periods beginning with January 1, 1996. Brazilian companies that file with the Commission for the first time and include audited financial statements for periods subsequent to January 1, 1996 should use the IGP for each period that US GAAP information is presented. To illustrate, if a Brazilian company files a registration statement with audited financial statements that are reconciled to US GAAP for 1998 and 1999, the company should use the IGP at a minimum for these two years. For periods prior to 1998, any comprehensive index that reflects actual inflation during the applicable period that the company represents is most appropriate in their circumstances would be acceptable.

2. Inflationary Status

For periods beginning after December 31, 1997, Brazil should no longer be considered a highly inflationary economy. Issuers will need to measure their Brazilian operations using the appropriate functional currency rather than the reporting currency.

B. Chile

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1. Translation of foreign subsidiaries

Under BT 64, the new Chilean foreign currency standard effective January 1, 1999, investments that are considered to be an extension of the Chilean parent's operations continue to be remeasured in Chilean pesos and price-level adjusted for the effects of inflation in Chile. Investments in stable countries, which are not considered to be an extension of the Chilean parent's operations, continue to use the local currency as the currency of measurement.

The primary difference between BT 64 and its predecessor relates to foreign investments made in unstable environments. Under BT 64 such investments are required to adopt the US dollar as the "functional currency", as the Chilean peso itself is not considered to be a stable currency.

The staff has not objected to the view that the adjustments made in respect of investments in unstable countries are part of a comprehensive basis of adjusting for inflation. Accordingly, differences between BT 64 and US GAAP do not need to be eliminated in the reconciliation to US GAAP.

The staff expects Chilean filers to disclose the following in the financial statements:

- Description of the methodology used to translate foreign operations
- Indication of which countries are considered to be stable vs. unstable
- The amount of the foreign exchange gain/loss included in income that is attributable to operations in unstable countries - that is, the effect of remeasuring transactions into US dollars.

In addition, MD&A should discuss the effects of the application of BT 64 on the registrant's results of operations and explain how the results are affected by changes in currency exchange rates and inflation rates.

Where material and necessary to an understanding of the registrant's results of operations, MD&A should also disclose the following:

- Year-end and average exchange rates. This will allow an investor to estimate the effect of using the year-end exchange rates.
- Average rates of inflation for the period. This will allow investors, with the information in the point above, to estimate what the results would have been had the amounts been presented in pesos of equivalent purchasing power.

2. Profit Distributions

Chilean companies are required to distribute 30% of their net income to shareholders unless a majority of shareholders approve the retention of the profits. The amount of retained earnings that is required to be distributed should not be considered permanent equity for purposes of US GAAP.

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C. Columbia - Price-Level Adjusting

As of January 1, 1992, Columbia began using price level accounting on a prospective basis. The effects of inflation not recognized in periods prior to 1992 when Columbia was hyperinflationary would result in a US GAAP difference. When presenting comparative financial statements in the US, Rule 3-20 of Regulation S-X requires all financial statements be retroactively restated to reflect constant currency as of the balance sheet date. Under Columbian GAAP, prior year financial statements are not restated. The requirement regarding the use of a constant currency of equivalent purchasing power must be applied in the primary financial statements. That is, it cannot be "corrected" in the reconciliation to US GAAP.

D. Capital Transactions - Earnings per Share

In most of Latin America, within the equity accounts is a "Restatement" account which represents the effect of restating capital stock to constant currency. There may also be designated reserve accounts and other accounts, such as "Results of Holding Non-Monetary Assets" in Mexico, which represent differences in appraisal values and indexation for inflation. It is not uncommon to transfer these reserves to capital stock and issue new shares to existing holders on a pro rata basis. The Task Force and the staff agreed that these transactions are most similar to a stock split or stock dividend, since each holder's pro rata ownership and total shareholders' equity remains unchanged. Therefore, these issuances should be treated as if they were outstanding for all periods presented for basic and diluted earnings per share, as required under FASB 128, paragraph 54.

IV. EUROPE

A. UK - Item 18 Disclosures

UK registrants should consider the need to provide disclosures stipulated by the Companies Act in filings with the Commission. The staff has been informally advised by the staff of the UK Accounting Standards Board that compliance with UK GAAP necessitates inclusion of disclosures required by the Companies Act to the extent that the disclosures relate to the balance sheet or income statement. Registrants that disclose that the financial statements filed with the Commission do not comply with the Companies Act are encouraged to explain the nature of the departure. In addition, the registrant should be able to justify why the departure does not affect the representation that the financial statements comply with UK GAAP.

B. Russia - Inflationary Status

While Russia's cumulative three-year inflation index appears to have dropped below 100% for a very brief period during 1998, the seriousness of the subsequent adverse developments there indicate that Russia should continue to be considered highly inflationary.

The inflationary status of the other former Soviet states should be evaluated individually, if applicable. The staff has noted instances where registrants from emerging countries have looked to industrial price indices

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or changes in currency exchange rates (devaluation) against the dollar rather than the general consumer price index. The staff has objected because these approaches conflict with FAS 52.

V. Israel

A. Approved Enterprise Zones

Israel has a tax incentive program for "approved enterprise zones". Under the alternative system of tax benefits, a company has a tax holiday for a specified period provided the profits generated during the exempt period are retained. If those profits subsequently are distributed, the company generally would owe taxes at the applicable rate.

Under FAS 109, a deferred tax liability normally would be recorded relating to taxes that would be owed on the distribution of profits even if management does not intend currently to declare dividends. However, under Israeli tax law, a company could be liquidated and profits distributed with no tax liability to the company; rather, the shareholders would incur the tax liability. If the registrant can represent that profits could be distributed tax free in a liquidation, and the undistributed earnings are essentially permanent in duration, a deferred tax liability does not need to be recorded.

If the approved enterprise benefit relates to a domestic (Israeli) subsidiary, the parent company would be liable for the taxes upon distribution. Accordingly, a deferred tax liability should be recorded unless the subsidiary could be merged with the parent in a tax free merger or if there is some other manner in which the earnings could be distributed tax free.

If deferred taxes are not provided for amounts that would be owed on distribution of profits, the following disclosures may be appropriate:

- a description of the approved enterprise zone program indicating if the benefit relates to the parent company or a subsidiary;
- the amount of retained earnings for which taxes have not been provided;
- a statement that such undistributed earnings are essentially permanent in duration;
- a statement that such earnings could be distributed to shareholders tax free in a liquidation, or if applicable, in some other manner;
- the tax rate to the company if the profits were distributed; and
- the amount of tax that would be owed if the profits were distributed.

B. Pension Plans

A typical Israeli retirement arrangement contains elements of both defined contribution and defined benefit plans. The arrangement includes deferred

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vested benefits that supplement primary benefits provided by the Government. While companies are not obligated to pre-fund the liability, many pre-fund it through managers' insurance and/or mutual funds. There is no legal defeasance, since the sponsor typically is the beneficiary of the funding arrangement.

Israeli registrants have properly not followed FASB Statement 87 in accounting for the deferred vested portion of the arrangement. EITF 88-1 applies to this arrangement. Under EITF 88-1, companies not using Statement 87 for deferred vested benefits should record the obligation as if it was payable at each balance sheet date (the so called "shut-down method"). The liability should be recognized on an undiscounted basis as contemplated by EITF 88-1.

Israeli registrants should disclose their accounting method for the deferred vested benefit arrangement, the amount of the related liability accrued and the related assets, if funded. Under Israeli GAAP the balance sheet amounts are shown net. US GAAP would require gross reporting. Registrants should also disclose the components of the net expense (income), that is, the gross expense and the income from the funding arrangement.

C. Government Grants

The Office of the Chief Scientist provides grants for research and development efforts. Under Israeli law, royalties on the revenues derived from products and services developed using such grants are payable to the Israeli Government. Royalties payable are capped at a percentage of the grants received on grants received before 1999. Royalties payable with respect to grants received under programs approved after January 1, 1999 are subject to interest on the dollar-linked value of the total grants received at an annual rate of LIBOR applicable to dollar deposits.

The amounts of grants received and recorded into income should be disclosed for each period presented. The research and development grants are presented in the statement of operations as an offset to related research and development expenses. If material, the amount of grants should be presented separately on the face of the statement, i.e., gross R&D less grants equals net R&D. Royalty expense should be classified as part of cost of sales, not as marketing expense.

In addition, the Government of Israel awards grants to Israeli companies for overseas marketing expenses. The companies are required to pay royalties in connection with such grants at specified rates up to the total dollar-linked amount of such grants. The marketing grants are presented as an offset to sales and marketing expense.

If it is probable that the registrant will have to repay any amount of the grants received, those amounts should be recorded as a liability and not recorded in income.

D. Devaluation Method

Most Israeli registrants derive a significant portion of their revenues outside Israel and report in US dollars. However, some registrants that operate

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largely within Israel report financial results in New Israeli shekels. Israeli GAAP allows companies to price level adjust financial statements prepared in New Israeli Shekels based on either (i) inflation as measured by the consumer price index or (ii) the devaluation of the Shekel to the US dollar. The staff believes the devaluation method does not reflect the change in the value of the currency in the primary economic environment and may be misleading in some circumstances if not supplemented with additional information relating to performance, liquidity and financial condition on a basis adjusted for changes in the consumer price index.

E. Price-Indexed Tax Systems

The currency of measurement, or functional currency, is the US dollar for many entities in Israel and certain other countries with price-indexed tax systems. The provisions of paragraph 9(f) of FAS 109 are applicable unless the registrant has elected to pay its taxes based on US dollar amounts. Paragraph 9(f) is an exception to the liability approach and stipulates that the effects of changes in exchange rates and indexing for inflation are excluded from the temporary differences in determining the deferred tax balances. The staff has been advised that a similar concept does not exist under Israeli GAAP. The staff has also concluded that the Israeli Inflationary Taxation System has the same effect as indexing. This issue may also arise for registrants that use IAS. While similar to FAS 109 in most respects, IAS 12 does not contain an exception comparable to paragraph 9(f). Registrants are encouraged to clearly describe how deferred taxes are determined, and if appropriate, address the provisions of paragraph 9(f) in the reconciliation to US GAAP.

VI. Asia

A. People's Republic of China

1. Consolidation of Joint Ventures

Foreign-owned businesses in the People's Republic of China are often conducted through foreign "joint venture" arrangements. The joint ventures are formed by the contribution of capital by the registrant, and contribution of an underlying project or business by a PRC municipal government entity (PRC partner). The joint venture typically acquires a long-term concession to operate the project or business.

Generally, the registrant owns the majority of the voting shares of the joint venture, and the PRC partner owns the remaining shares. The registrant also selects a majority of the directors of the joint venture. However, unanimous approval by the board of directors is required for numerous operating decisions. Examples include selection and termination of key operating and financial officers, approval of budgets, capital expenditures and borrowings in the ordinary course of business. One arrangement required unanimous approval of all matters pertaining to the planning, construction, operation, and maintenance of the joint venture's only revenue generating project.

Where the PRC partner's rights are substantive and pervasive, they should not be considered "protective" as contemplated in EITF 96-16. Where the

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PRC partner retains significant rights and authority over operating decisions despite relinquishing majority ownership, the staff believes that the registrant does not have a controlling financial interest in the joint venture.

These arrangements also create various presentation issues. If consolidation is permitted under home-country GAAP, reconciliation of all financial statement captions likely will be required. In the selected financial data, the staff would expect home-country and US GAAP amounts to be presented with equal detail and prominence.

Separate audited financial statements of each joint venture under Rule 3-09 of Regulation S-X may be necessary. If consolidation is permitted under home-country GAAP, the staff will consider accepting expanded footnote disclosures about the joint ventures, such as separate condensed balance sheet, income statement, and cash flow information for each joint venture, in lieu of Rule 3-09 financial statements. Also MD&A should address the significant presentation differences between home-country GAAP, and include meaningful discussion of the results of operations, liquidity and cash flows of the ventures and their impact on the registrant.

In some of these arrangements, an affiliate of the PRC municipal government provides financial support in certain circumstances. Where significant, financial statements or other financial information about the affiliate may be required.

2. Fixed Asset Revaluation - IAS 16

Government-owned enterprises in the Peoples Republic of China contemplating a public offering of securities undergo a process of "corporatization". As part of that process, property, plant and equipment are adjusted to fair value shortly before the filing of the registration statement. Unlike government owned enterprises in certain countries, PRC government-owned enterprises generally maintain historical cost records for property, plant and equipment, although government policy rather than market forces may have determined those costs. Property, plant and equipment typically are not revalued prior to the time of corporatization.

IAS 16 allows property, plant and equipment to be measured subsequent to initial recognition at historical cost (benchmark treatment) or at revalued amounts (allowed alternative). When the revaluation method is used, IAS 16 requires revaluations to be made "with sufficient regularity such that the carrying amount does not differ materially from that which would be determined using fair value at the balance sheet date."

The staff has distinguished this fact pattern from the establishment of cost by appraisal at the beginning of the earliest period presented in the context of a privatization when historical costs might not be possible to ascertain. The staff has taken the following position where historical cost can be ascertained:

- Revaluation is an IAS/US GAAP difference that must be reconciled.
- The accommodation for a one-time appraisal to establish initial carrying amounts for US GAAP does not apply unless reliable

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historical cost records have never been maintained.

- The periodic revaluation guidance in IAS 16 must be applied subsequent to the time of corporatization.

More detailed guidance is provided in the highlights of the May 2000 meeting of the AICPA International Practices Task Force.

B. Taiwan - Stock Bonuses

Under Taiwan GAAP, employee bonuses and remuneration to directors and supervisors are paid in accordance with a company's articles of incorporation subsequent to year-end and are subject to shareholder approval. The bonuses may be settled in either cash or stock depending on the provisions of the articles of incorporation. In many cases, the bonuses are settled in stock. For local valuation purposes, only the par value of the stock is considered. As a result, it is common in Taiwan for shares to be issued whose value would significantly exceed the amount of the cash compensation. Some believe that for US GAAP purposes, the fair value of the shares should, at a minimum, be accrued at December 31, with the difference between that amount and the amount ultimately paid (based on the value at the shareholders' meeting) charged to income in a subsequent period. The staff places significant weight on shareholder approval. Accordingly, absent unusual facts and circumstances, the fair value of the stock issued should be recorded at the date of shareholder approval.

http://www.sec.gov/divisions/corpfin/internatl/issues0501.htm

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