CAQ International Practices Task Force (IPTF)

November 20, 2007 - Joint Meeting with SEC Staff

Discussion Document A

Topic: Measuring assets and determining their location for the purpose of performing the asset test component of the definition of a foreign private issuer

Background

Under Rules 405 of the Securities Act and 3b-4 of the Exchange Act, the definition of a foreign private issuer is as follows:

> "…any foreign issuer other than a foreign government except an issuer meeting the following conditions:
>
> More than 50 percent of the outstanding voting securities of such issuer are directly or indirectly owned of record by residents of the United States; and
>
> Any of the following:
>
> - The majority of the executive officers or directors are United States citizens or residents;
> - More than 50 percent of the assets of the issuer are located in the United States; or
> - The business of the issuer is administered principally in the United States."

The evaluation of a registrant's status in relation to the criteria outlined above is a matter of legal interpretation. However, as the asset test involves accounting measurements, accountants may be asked for their views as to its application. While not seeking formal guidance, this document attempts to clarify the Staff's views on how the asset test may be applied, by providing examples of acceptable methods.

There is no formal guidance on measuring or determining the location of assets in applying the asset test. However, in an article[1] that has been widely cited as helpful in applying the foreign private issuer tests, the author indicates, "the SEC staff is frequently asked for guidance in applying the asset test, but has declined to respond, other than to suggest informally that an accounting approach may be an appropriate place to begin."

The "accounting approach"

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[1] Folsom Kinsey, Sandra. "Foreign Private Issuers." The Review of Securities & Commodities Regulation (April 25, 2001): 79-88.

Under the accounting approach, in performing the asset test, the company could apply the measurement methodology in the underlying financial statements prepared under US GAAP, or the GAAP used in the primary financial statements if the financial statements are reconciled to US GAAP. This may be the preferred methodology from a practical standpoint, because the company will likely have the systems in place to perform the test regularly. Under the accounting approach, the location of the assets would be the same as that determined in financial reporting for purposes such as segment information.

Alternatives to the accounting approach

There may be a variety of alternatives to using strictly an accounting approach. The following methodologies, to the extent not used in the primary financial statements, may be considered:

Use of fair value for measurement purposes:

If a registrant that has all of its operations outside of the U.S. acquires a company with all of its operations inside the U.S., it may record a significant amount of goodwill. As a result, under the accounting approach, a disproportionate amount of assets may be associated with the U.S. operations, relative to the actual fair value of the combined entity. In such a situation, a company may choose to use a full fair value approach, rather than the values stated in its financial statements, for applying the Asset Test. In other words, if company determined the fair value of the assets in the U.S., compared it to the fair value of the assets of the consolidated group and determined that less than 50% of the fair value of the assets were in the U.S., it may conclude that less than 50% of the assets are not in the U.S. even if the amounts under GAAP would indicate that over 50% of the assets were in the U.S.

It should also be noted that, in the above example, if the historical cost basis is used under the GAAP of the primary financial statements, but that GAAP also permits the use of fair values for measuring certain assets, the fair value methodology permitted by that GAAP may be used.

Use of historical cost basis for measurement purposes:

If a fair value measurement method is used under the GAAP of the primary financial statements, the historical cost basis permitted by that GAAP may be used for purposes of the asset test.

Use of allocation methodologies that differ from those used for segment disclosure:

It is possible that the allocation methodology used in the foreign private issuer asset test may differ from that underlying the presentation of segment assets or entity wide assets on a geographical basis under SFAS 131. Following are examples of such differences:

Cash and cash equivalents – In connection with segment disclosure, the location of cash and cash equivalents may be presented based on where such cash and cash equivalents are kept. Cash and cash equivalents may be kept in the U.S. by a company to fund the U.S. operations. A company might also keep cash in the U.S. as part of an investment decision under a centralized treasury operation where such cash can be transferred to another location easily. It may be reasonable to treat cash and cash equivalents kept in the U.S. to fund U.S operations as located in the U.S. while cash and cash equivalents kept in the U.S. strictly for investment purposes may not be included as asset located in the U.S.

Other financial instruments - In connection with segment disclosure, the location of other financial instruments, such as derivatives, may be the legal or contractual location of such an instrument, which may have little relation to the objective for which the instrument was acquired. The determination of the location of such assets may require evaluation of the facts of the underlying contracts and the reasons for acquiring the instrument.

Trade receivables - In connection with segment disclosure, the location of trade receivables may be determined by the location of the business unit that has made the related sale. However, another factor that might be considered is the location of the debtor.

Cost method investments and equity method investees – In connection with segment disclosure, the location of cost method investments and investments in equity method investees may be determined by the location of the entity that owns the shares of the investee. However, it is possible that the location of the business operations of the investee has little relation to the location of the entity that owns its shares. In such cases, the location of the investee's operations may be considered.

Other tangible assets - In connection with segment disclosure, the location of tangible assets may be determined by where they are physically located. However, there may be circumstances under which a portion of the value of tangible assets is allocated to a location other than where the asset is physically located. For example, computer hardware might have software embedded in it. The hardware may be used in one location while the software might be used by several locations. Some companies may have an information system housed in one location, but being used by multiple countries. In these situations, it may be reasonable to allocate the value of the assets according to their use.

Intangible assets - In connection with segment disclosure, the location of an intangible asset may be the location of the entity that holds the asset. However, if an intangible asset such as brand, patent or trademark is used in more than one country, a company might allocate the value of the asset to countries where it is used, in proportion with revenue or some other rational measure of the use of the asset.

It is possible that in applying the above alternative methodologies to the use of the accounting approach, a registrant may use a GAAP other than that used in preparing the primary financial statements. For example, a company that presents its financial statements under US GAAP for purposes of filing its Form 20-F, but reports its results in its home country GAAP locally, may use home country GAAP for its asset test.

It should be noted that while the Commission's rules are silent as to how frequently a company needs to perform the asset test, in a no-action letter issued in 1993[2], the Staff indicated that the test should be performed, at a minimum, on a quarterly basis, but also upon the occurrence of certain transactions. From a practical standpoint, therefore, the use of a methodology other than the accounting approach may result in significant incremental effort on a quarterly basis.

Additionally, once a registrant has selected a methodology in performing the asset test, it should be applied on a consistent basis, unless a clear change in circumstances warrants a reassessment.

The Task Force seeks the Staff's confirmation that it is unlikely to object to a particular measurement or allocation methodology, including those outlined above, as long as it is rationally based and rigorously applied, without considering in advance what the likely result will be.

<u>SEC Staff Response:</u> ***The staff agrees with the Task Force's view. With respect to the frequency of testing described in the third-to-last paragraph above, the staff notes that when the recently adopted Foreign Issuer Reporting Enhancements (SEC Release 33-8959) become effective in late 2008, foreign private issuers will be required to test their status only once per year.***

[2] Letter to Reed, Elliot, Creech & Roth (available March 30, 1993)