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PRACTICAL COMPANY EXPERIENCE IN ENTERING U.S. MARKETS: SIGNIFICANT ISSUES AND HURDLES FROM THE ADVISOR'S PERSPECTIVE

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At Bear Stearns, I'm a Managing Director in the Equity Research Department, not in the Corporate Finance Department. In other words, I'm a financial analyst, not an investment banker. In Equity Research, I am responsible for tracking tax law changes and Financial Accounting Standards Board ("FASB"), International Accounting Standards Committee ("IASC"), and Securities and Exchange Commission ("SEC") accounting rule changes. I write a newsletter for institutional investors describing the investment implications of these changes.

For years, I have been a resource for the investment bankers. I'm not involved with every deal, or even most of the deals Bear Stearns does. My role is more that of a trouble-shooter. Frequently I am asked to give guidance on how a new transaction that our bankers are proposing to clients might be taxed or accounted for. Sometimes I'm asked to assess a company's accounting practices as part of the due diligence process. This generally happens when a company uses accounting methods that the banker is not familiar with.

Keeping in mind that Bear Stearns will be marketing the deal and needs to protect its clients, its credibility, and its franchise, I generally look at a company's accounting practices through the eyes of a financial analyst and not an accountant's.

Frequently, there are choices in accounting principles a company might choose (for example, a choice of LIFO or FIFO for inventory accounting) or judgments in the way a single accounting principle could be applied (for instance, the life over which goodwill should be amortized). Some choices provide better quality information to the investment community than others. In looking at the company's accounting practices, I am

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not simply concerned with whether a company follows generally accepted accounting principles ("GAAP"), but whether it is the best choice of GAAP in the circumstances and whether all of the disclosures necessary for an investor to assess the risks inherent in the enterprise have been made.¹

My involvement in transactions with foreign issuers has been varied. It has ranged from the basic, contrasting a company's home country standards to U.S. GAAP, to the complex, evaluating whether the accounting being used, be it home country accounting or U.S. GAAP, appropriately captures the economic substance of a transaction or a company.² My experience has led me to conclude that the accounting practices and disclosures that U.S. market participants have come to accept and expect are a significant part of the capital-raising process. They need to be carefully considered by any prospective foreign issuer.

A foreign company should be prepared to address several issues. First, how does the home country GAAP differ from U.S. GAAP and, more importantly, why? Second, what industry-specific practices does the company use in its home country, and how do these differ from similar industry practices in the United States; and again, why? Third, are there transactions that the company is engaged in for which U.S. accounting rules and/or home country accounting rules do not exist, or that U.S. investors are unfamiliar with? Fourth, how difficult, in terms of both time and cost, will it be for the company to gather the information necessary to fulfill the U.S. disclosure requirements? Finally, how to get comfortable about providing the types of information normally disclosed in the United States, that foreign management fears will lead to dissemination of sensitive information?

For a foreign company thinking of issuing securities in the United States for the first time, the initial step is to understand the U.S. markets — not just the regulatory requirements, but what makes the markets tick, what makes them liquid and efficient. A significant part of what makes the market tick is the

1. See M. Shane Warbrick, *Practical Company Experience in Entering U.S. Markets: Significant Issues and Hurdles from the Issuer's Perspective*, 17 FORDHAM INT'L L.J. S112, S113-14 (1994) (describing rationale in employing U.S. GAAP for registration of Fletcher Challenge Ltd.).

2. *Id.*

accounting and disclosure system. Many have suggested that the primary obstacle to a foreign company wishing to list securities in the United States is the SEC requirement that a foreign company either present financial statements in accordance with U.S. GAAP or disclose and quantify the effects of any significant differences between the foreign principles used and U.S. GAAP.³

I disagree that this is an obstacle. Generally speaking, I find the U.S. disclosure system is currently superior to most others in the world because it provides the most relevant information for investors.⁴ When I make this statement I am not simply referring to the numbers that appear in the balance sheet, income statement, and statement of cash flows, as important as the reported numbers are. I am also referring to the footnote requirements contained in APB opinions, FASB statements, and disclosure requirements of the SEC, such as the very useful Management Discussion & Analysis ("MD&A"). I believe that the information provided by this system is one of the primary reasons why the U.S. capital markets are among the most liquid and efficient in the world.

I think that a foreign issuer that studies and understands our markets, whether they like it or not, will ultimately come to the same conclusion. For example, a foreign issuer studying the regulatory requirements may conclude that a 144A offering⁵ is

3. Regulation S-X, 17 C.F.R. § 210.4-01(a)(2) (1993) (requiring foreign issuers to reconcile their financial statements to U.S. GAAP); see Richard C. Breeden, *Foreign Companies and U.S. Securities Markets in a Time of Economic Transformation*, 17 FORDHAM INT'L L.J. S77, S86-96 (1994) (discussing requirement that non-U.S. company entering U.S. capital markets reconcile financial statements to U.S. GAAP); William Decker, *The Attractions of the U.S. Securities Markets to Foreign Issuers and the Alternative Methods of Accessing the U.S. Markets: From the Issuer's Perspective*, 17 FORDHAM INT'L L.J. S10, S23-24 (1994) (discussing requirement that non-U.S. company entering U.S. capital markets reconcile financial statements to U.S. GAAP); James L. Cochrane, *Are U.S. Regulatory Requirements for Foreign Firms Appropriate?*, 17 FORDHAM INT'L L.J. S58, S61-67 (1994) (discussing requirement that non-U.S. company entering U.S. capital markets reconcile financial statements to U.S. GAAP); M. Elizabeth Rader, *Accounting Issues in Cross-Border Securities Offerings*, 17 FORDHAM INT'L L.J. S129, S135-37 (1994) (discussing requirement that non-U.S. company entering U.S. capital markets reconcile financial statements to U.S. GAAP).

4. Compare Breeden, *supra* note 3, at S87-88 (noting that U.S. GAAP has flaws but provides disclosure that is much valued in U.S. capital markets) and Warbrick, *supra* note 1, at S113-14 (describing how Fletcher Challenge Ltd. utilized U.S. GAAP in registration process) with Cochrane, *supra* note 3, at S61-67 (arguing that U.S. GAAP impedes registration process of foreign issuers).

5. 17 C.F.R. § 230.144A (1993).

more efficient because it avoids much of the accounting and disclosure a registered offering would involve.⁶ However, on reflection, it may find its goal of capital formation, liquidity, and efficiency better achieved by a registered offering.⁷ We have seen this happen with Mexican companies, such as Telemex. They get their feet wet — or whetted their appetites, as the case may be — by doing a 144A offering, but it isn't too long before they are seeking a stock exchange listing and then a public offering.

Whether it decides on a 144A offering or a listing, the foreign issuer needs to understand that our markets are used to having more information and more access to management than is true in most countries.⁸ They should be prepared for intense scrutiny and frequent criticism from the investment community.

Next, the foreign issuer needs to understand how its home country accounting standards differ from those in the United States and why?⁹ All accounting systems are based on the same algebraic formula: assets equal liabilities plus shareholders' equity. However, it always amazes me that there are so many ways that debits and credits can be arranged for the same transaction and still keep this formula in balance. The reason for the differing debits and credits, generally speaking, is that different countries have different explicit or implicit conceptual frameworks.¹⁰

The conceptual differences between accounting systems generally lead to dicey issues of income measurement. For example, in the United States, the concept of conservatism is now practically a dirty word. FASB Concept Statement No. 2, "Qualitative Characteristics of Accounting Information," states in part:

6. *Id.* A 144A offering does not require registration, provided that the issuer sells its securities to a qualified institutional buyer. *Id.* § 230.144A(d)(1); see Decker, *supra* note 3, at S14-15 (discussing requirements of Rule 144A transactions); Frode Jensen, III, *The Attractions of the U.S. Securities Markets to Foreign Issuers and the Alternative Methods of Accessing the U.S. Markets: From a Legal Perspective*, 17 *FORDHAM INT'L L.J.* S25, S35-37 (1994) (discussing requirements and limitations of Rule 144A transactions); Joseph Velli, *American Depository Receipts: An Overview*, 17 *FORDHAM INT'L L.J.* S38, S53-56 (1994) (discussing requirements and limitations of Rule 144A transactions).

7. See Form F-1, 17 C.F.R. § 239.31 (1993) (describing required registration form for initial public offerings by non-U.S. issuers).

8. See Jensen, *supra* note 6, at S27 (describing disclosure based principles of Securities Act).

9. See Warbrick, *supra* note 1, at S116-17 (1994) (discussing differences between U.S. accounting standards from New Zealand accounting standards).

10. *Id.* at S114 (noting different conceptual approaches between U.S. accounting standards and New Zealand accounting standards).

“Conservatism no longer requires deferring recognition of income beyond the time that adequate evidence of its existence becomes available or justifies recognizing losses before there is adequate evidence that they have been incurred.”

In contrast, France and Germany adhere to a concept referred to as the “prudence principle.”¹¹ This concept leads to the conclusion that it is inappropriate to mark investment securities to market since doing so requires the recognition of unrealized profits. In the United States, the generally prevailing view, at least among regulators, is that marking to market produces the conceptually superior result.

Another area where there appears, at least on the surface, to be a conceptual difference between the U.S. accounting system and that of other countries is in the area of inflation accounting. In many countries experiencing high rates of inflation they use a method of inflation accounting, generally known as “price level restatement.” This produces financial statements denominated in currency of constant purchasing power. In the United States, we remain wedded to an historic cost model. However, price level accounting does not violate the U.S. historic cost concept because it is simply a mathematical adjustment of the numbers produced by an historic cost system.

A system of inflation accounting based on another system, such as current cost, violates the historic cost concept. Therefore, in theory, it would be unacceptable under U.S. GAAP. Fortunately, the SEC recognizes that during periods of inflation unadjusted historic cost financial statements show illusory profits and capital erosion is masked. Thus, under the SEC rules, if a country uses a comprehensive inflationary accounting system, the effects may continue to be reflected in a company’s financial statements; thus, inflation adjustments are not a reconciling item in a foreign issuer’s U.S. GAAP reconciliation.¹²

11. DAVID ALEXANDER & CHRISTOPHER NOBES, *A EUROPEAN INTRODUCTION TO FINANCIAL ACCOUNTING* 397 (1993).

12. Form 20-F, Item 18(c)(3)(iii), 5 Fed. Sec. L. Rep. (CCH) ¶ 29,701, at 21,745 (Nov. 18, 1992). Item 18(c)(3)(iii) of Form 20-F exempts a foreign issuer from reconciling inflation adjustments.

For an issuer in a hyperinflationary economy that comprehensively includes the effects of price level changes in its primary financial statements, the quantification of variations required by this paragraph shall not include such effects. A reasonably prominent headnote to the financial statements shall de-

Still, when inflation accounting is used, there is a significant investor education process. Many market participants today are too young to remember the double-digit inflation that the United States experienced in the 1970s and early 1980s and the various SEC and FASB experiments with inflation-adjusted information.

The investment community needs to be taught how to use and interpret the information they are provided. They need to be convinced that it is reliable and not just some gimmick used to mislead them. This task takes time and patience, but it pays off in the long run.

An understanding of these conceptual differences and similarities between its system and the U.S. system will enable foreign management to explain its home country financial statements to its investment bankers and to U.S. investors in terms that they understand. In addition, if it decides to present financial statements in U.S. GAAP, an understanding of the concepts underlying the U.S. rules will help management to make judgments in applying U.S. GAAP that are consistent with the intent of the standards.

After management has an understanding of the conceptual differences, it needs to identify the company-specific differences between its home country statements and financial statements prepared in accordance with U.S. GAAP.¹³ This is necessary even if the company is doing a 144A transaction because a verbal explanation of the differences, although without quantification, is required even then.¹⁴

Depending on the country and the industry involved, the foreign issuer may be pleasantly surprised to find that the differences, while material, are few and easily handled. This apparently was the case when Daimler-Benz finally buckled down and did an analysis of what would be required to conform to U.S. GAAP. During a recent speech, Dr. Gerhard Liener, the Chief Financial Officer of Daimler-Benz, said that during the prepara-

scribe the basis used to prepare the financial statements. The reconciliation shall state that such effects have not been included in the reconciliation.

Id.

13. See Regulation S-X, 17 C.F.R. § 210.4-01(a)(2) (1993) (requiring foreign issuers to reconcile their financial statements to U.S. GAAP)

14. 17 C.F.R. § 230.144A(d)(4) (1993).

tion of its SEC Form 20-F,¹⁵ Daimler found out “that indeed some of the differences between our two accounting systems were not that striking as they were perceived to be.”¹⁶ He noted that the percentage of completion method used in the United States is fairly well duplicated by the German milestone system; a good guideline for setting up reserves under U.S. GAAP is given by the German tax accounting rules; and leasing, depreciation, manufacturing cost, and pension provisions were areas where Daimler was able to keep its procedures or where the differences in calculations were immaterial.¹⁷

Next, the company needs to identify any transactions for which U.S. GAAP may not exist or which U.S. investors are not familiar with.¹⁸ Examples might include government grants or government concessions, such as those used in Mexico to encourage infrastructure improvement. Such transactions may require consultation with the SEC, particularly if the home country has no promulgated standard for handling such transactions or if alternatives exist in the home country.¹⁹ Special care will need to be taken in the prospectus to clearly explain these transactions and the accounting principles applied.

After the differences are isolated, the truly formidable task begins: gathering the information necessary to conform or reconcile the statements to U.S. GAAP. Management should be aware that gathering such information, compiling it into the required format, and getting auditors and investment bankers comfortable with it can be a very lengthy process.²⁰ They should keep this in mind when forming expectations about the timing of securities offerings. Because of SEC requirements regarding the timeliness of the financial information included in the pro-

15. 17 C.F.R. § 249.220f (1993).

16. See Warbrick, *supra* note 1, at S113-17 (detailing difficulty in reconciling with U.S. GAAP).

17. Dr. Gerhard Liener, Management Board Member of Daimler Benz, Entering the U.S. Accounting World — A View from the First German Player, Remarks at the Conference on the International Capital Markets and Harmonisation of International Accounting Standards, London, June 29, 1993.

18. See Warbrick, *supra* note 1, at S113-17 (detailing how U.S. GAAP fails to address certain issues covered by New Zealand accounting methods).

19. *Id.* at S117-18 (describing how Fletcher Challenge Ltd. met with staff of SEC to resolve certain issues prior to registration).

20. *Id.*; see Decker, *supra* note 3, at S20-21 (acknowledging role of key players in registration process); Jensen, *supra* note 6, at S33-34 (highlighting role of management in registration process).

spectus, missing a deadline can mean a substantial delay in the offering.

The availability of the data is generally one of the primary obstacles to preparing a registration statement.²¹ The information that is generally most difficult — and in fact sometimes impossible — for a foreign issuer to provide is certain footnote disclosures, such as the market value of investments on an historical basis, historical property, plant and equipment data, and the earliest years of the five-year selected data table. My experience with the SEC is that it is very flexible regarding missing historical information.²²

Management's perceptions of the sensitivity of required disclosures, such as segment information and the MD&A, which requires discussion of the company's outlook, can be another major obstacle.²³ My experience has been that in the end, however, business considerations generally override all of these perceived obstacles.

Increased disclosure is the key to efficiently accessing the largest equity capital market in the world. The more information provided to the investment community, the clearer that information is presented, the more transparent the company becomes to both national and international investors, making it a more attractive investment, which in turn raises its stock price and lowers its cost of capital.

The process I have just described is costly to comply with and hinders all sorts of cross-border transaction and performance analysis. There needs to be a common link between the needs of investors in capital markets and requirements imposed on companies with multi-jurisdictional offerings. There needs to be a streamlining of the process without the loss of information useful to investors.

While I am here, let me put in a plug for the IASC. Formed twenty years ago, the IASC works for the harmonization of financial reporting primarily through the development and publica-

21. See Decker, *supra* note 3, at S18 (discussing "availability issue" in registration of non-U.S. companies entering U.S. capital markets).

22. See Richard Kosnik, *The Role of the SEC in Evaluating Foreign Issuers Coming to U.S. Markets*, 17 *FORDHAM INT'L L.J.* S97, S97-99 (1994) (noting flexibility of SEC in accommodating and assisting non-U.S. issuers).

23. See Decker, *supra* note 3, at S18 (discussing "sensitivity issue" of disclosures in registration of non-U.S. companies entering U.S. capital markets).

tion of International Accounting Standards ("IAS"). The IASs are developed through an international due process that involves the accounting profession, the users of financial statements, the business community, intergovernmental organizations, and national standard-setting bodies.

The International Organization of Securities Commissions ("IOSCO") has been working closely with the IASC to agree on a set of mutually acceptable international standards for use in multinational securities offerings. Several years ago, IOSCO identified three broad areas requiring action by IASC before regulators could consider acceptance of IASs in financial statements used for securities offerings. The first area concerned a reduction of free choices of accounting treatments under existing IASs and the establishment of a benchmark treatment when the standards continue to allow a choice. The second area entailed the revision of existing Standards to improve disclosure requirements and add implementation guidance. The third area involved the continuation of the process of identifying accounting areas not covered by existing Standards, and, as a consequence, the development of new IASs to achieve a sufficiently complete set of standards.

IASC began work on the first area in 1987 and on the second in 1990. This became known as the Comparability and Improvements Project. Earlier this month, IASC finalized the ten Standards that are the core of this Comparability and Improvements Project. In addition, as mentioned earlier, there was another important milestone in the development of IASs this month. The SEC proposed adoption of IAS No. 7 for preparation of cash flow statements for use by foreign companies selling securities in the United States.

By the end of 1994, IOSCO intends to consider recommending the use of IASC Standards in multinational securities offerings. If that effort is successful, international companies will be able to offer their securities on world markets using one set of standards, and investors will need to understand only one accounting standard, besides their home country standard, to evaluate investment choices. This should lower the cost of raising capital and improve the efficiency of all capital markets.

I encourage you to support the efforts of the IASC and IOSCO.